STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

CASE 07-M-0906 - Iberdrola, S.A., Energy East Corporation, RGS Energy Group, Inc., Greene Acquisition Capital, Inc., New York State Electric & Gas Corporation and Rochester Gas and Electric Corporation – Joint Petition For Approval of the Acquisition of Energy East Corporation by Iberdrola, S.A.

STAFF INITIAL BRIEF

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PRELIMINARY STATEMENT

In a petition filed August 1, 2007, Iberdrola, S.A. (Iberdrola), Energy East Corporation (Energy East), New York State Electric & Gas Corporation (NYSEG), Rochester Gas and Electric Corporation (RG&E), and several other entities (collectively, the petitioners) request approval, under Public Service Law (PSL) §70, of Iberdrola's acquisition of Energy East. As the petitioners have structured the transaction, Iberdrola would purchase all of the outstanding common stock of Energy East, which, in turn, is the sole owner of the NYSEG and RG&E transmission and distribution (T&D) gas and electric utilities. The petition is Exhibit 41 in this proceeding.

On November 28, 2007, the petitioners filed the direct testimony of Dr. William Hieronymus in support of their request for approval of the proposed transaction. On January 11, 2008, other parties to the proceeding filed their initial testimony. The filing parties included: the City of Rochester (Rochester), Department of Environmental Conservation (DEC), Department of Public Service Staff (Staff), Greater Rochester Enterprise (GRE), International Brotherhood of Electrical Workers, System Council U-7 and Local 36 (IBEW), Independent Power Producers of New York, Inc. (IPPNY), National Resources Defense Council (NRDC), the New York State Rural Electric Cooperative Association (Rural-Co-ops), and Nucor Steel Auburn, Inc. (Nucor). The petitioners filed testimony in rebuttal to other parties on January 31, 2008.

Hearings concerning the petition and the testimonial filings were conducted commencing on March 17, 2008 and concluding on March 20, 2008. Parties participating in the hearings, in addition to the parties filing testimony, included: Astoria Generating Company, LLP and AES Eastern Energy, LLP (AES), Consumer Protection Board (CPB), Empire State Development Corporation (ESD), Multiple Intervenors (MI), the Retail Energy Supply Association and Small Customer Marketer Coalition (SCMC), and Strategic Power Management, LLC (SPM). At the hearings, 136 exhibits were entered into the record, and 1,908 pages of stenographic minutes (SM) were taken.

Moreover, on March 14, 2008, petitioners submitted a Partial Acceptance Document (Partial Acceptance) for consideration in this proceeding. The Partial Acceptance describes certain concessions that the petitioners would make, if the concessions are made conditions to an approval of the transaction and no other conditions are imposed. The Partial Acceptance is Exhibit 50 in this proceeding. Staff responded to the partial acceptance with supplemental direct testimony, at SM 1455-1480.

SUMMARY OF POSITION

Staff opposes approval of Iberdrola's acquisition of Energy East because the transaction poses unacceptable risks to the interests of NYSEG and RG&E ratepayers. To obtain approval of the transaction under PSL §70, petitioners must show that the transaction is in the public interest, by demonstrating that the benefits the transaction outweigh risks and detriments. Petitioners have failed to satisfy this test, as it has been applied in Commission decisions on energy utility acquisitions and mergers over the past decade, and, most recently, as applied in the review of National Grid's acquisition of KeySpan Corporation decided less than a year ago.[1]

Staff's Presentation

The financial and structural risks attending Iberdrola's acquisition of Energy East preclude approval of the transaction. These risks would arise out of the ownership of

[1] Case 06-M-0878, National Grid plc and KeySpan Corporation, Order Authorizing Acquisition Subject to Conditions and Making Some Revenue Requirement Determinations For KeySpan Energy Delivery New York and KeySpan Energy Delivery Long Island (issued September 17, 2007)(KeySpan/Grid Order).

NYSEG and RG&E by Iberdrola, a company that: engages in numerous un-regulated businesses in both the U.S. and elsewhere that are financially risky; has invested heavily in lightly-regulated or federally-regulated U.S. energy businesses; and, operates delivery utilities and generation facilities across Europe and Latin America. Moreover, besides the risks that attend an operation of such scope and scale, Iberdrola faces financial risk as a result of its ambitious investment goals, the potential for its involvement in other acquisition transactions, and the goodwill it will carry on its books if the transaction closes. NYSEG and RG&E ratepayers are not shielded from the risks attending ownership by an entity of such complexity that is confronted with such financial challenges.

Petitioners have not proposed structural and financial protections adequate to protect New York ratepayer interests. Accordingly, Staff proposes a full panoply of financial and structural protections that should accompany the approval, including insulation of NYSEG and RG&E from the bankruptcy of affiliates, a code of conduct, and reporting and accounting requirements. These financial and structural protections, taken directly from the Commission's KeySpan/Grid Order, are needed to ensure that the adverse consequences of any financial problems the Iberdrola holding company or any of its subsidiaries might encounter are not visited upon regulated New York ratepayers.

If the Commission does not deny approval of the transaction, it should require the financial and structural protections Staff proposes as conditions of approval.

Iberdrola’s acquisition of Energy East also poses an unacceptable potential for the exercise of vertical market power, because the transaction will combine into one holding company the NYSEG and RG&E transmission and distribution (T&D) utilities and subsidiaries of Iberdrola that own generation units sited in upstate New York, and plan to build more such generation there. Moreover, Energy East, NYSEG and RG&E continue to own substantial amounts of generation in upstate New York, including larger-sized gas-fueled facilities, notwithstanding the Commission’s policies favoring divestiture of that generation. The continued ownership of this generation by these T&D companies exacerbates the adverse market power impacts attending the transaction. Full divestiture of all the generation Iberdrola and Energy East own, and their complete exit from the generation business in New York, is needed to fully protect ratepayers from the pernicious effects of vertical market power.

Even if the unacceptable risks the transaction poses are mitigated, to obtain approval, the petitioners must show ratepayers will receive tangible monetary relief, attributable to the transaction that is reflected in the rates they pay. The petitioners did not propose any such tangible benefits. The non-monetary benefits they have presented are illusory and insufficient to justify the transaction’s approval. Given the substantial risk the transaction poses even after mitigation of financial, structural and vertical market power risks to ratepayer interests, substantial monetary benefits are needed to outweigh the inherent risks that remain.

Staff identifies sources and means for furnishing the requisite monetary benefits to ratepayers, by proposing Positive Benefit Adjustments (PBAs). These write downs of regulatory assets and write ups of regulatory credits will, when recognized in rates, yield the monetary benefits ratepayers are entitled to under the KeySpan/Grid Order. The PBAs should be made a condition of any approval of the transaction.

In the event approval of the transaction is granted upon conditions, however, it is essential that the benefits directed to ratepayers are preserved in rates. With respect to those rates, NYSEG and RG&E are each currently over-earning, while simultaneously facing upward pressure on rates in the future. As a result, approval of the transaction should carry with it a requirement that NYSEG and RG&E file rate plans, that will be implemented promptly, which will properly preserve the PBA benefits for ratepayers, address over-earnings, provide for rate stability in the future, promote safe, adequate and reliable service quality, and implement all applicable Commission policies. Staff outlines the rate and other conditions that such rate plans should reflect.

Petitioners’ Presentation

In opposing Staff’s positions, the petitioners have failed to meet the requirements the Commission established for obtaining approval of a transaction such as this in its recent KeySpan/Grid Order. There, the Commission addressed the financial and structural protections, vertical market power conditions, monetized ratepayer benefits, and rate filings necessary to justify approval of a transaction that resembles Iberdrola’s acquisition of Energy East in all important respects.

Instead of satisfying the requirements of that Order, the petitioners’ primary argument is that its requirements are inapplicable to Iberdrola. If it does apply, they claim they have satisfied its provisions, if the concessions made in the Partial Acceptance are considered. Neither argument is persuasive.

Petitioner witness Meehan compares Iberdrola’s acquisition of Energy East to acquisitions of water utilities. Plainly, such comparisons are inapposite. Petitioner Witness Makholm, in maintaining that financial and structural risks do not attend the transaction, bases his presentation on a concept he denominates as the "regulatory compact." But New York courts have rejected that concept. Witness Makholm also denies the very existence of the concept of ring-fencing, as that concept has developed over the past decade in the U.S., and as the Commission implemented it through the financial and structural protections adopted in the KeySpan/Grid Order. Petitioner Witness Fetter presents an analysis of risk that disregards both recent experience and Iberdrola's circumstances.

The petitioners' presentation on vertical market power is openly hostile to the Commission's KeySpan/Grid Order and the Commission's vertical market power policies. Indeed, petitioner Witness Hieronymus describes the vertical market power analysis detailed in the KeySpan/Grid Order as "utter nonsense" (SM 891).

Petitioner witness Meehan also argues that there is no need for the petitioners to offer monetary benefits in order to obtain approval of the transaction. Moreover, the petitioners attack Staff's PBAs conceptually and by criticizing Staff's calculations. These positions lack merit as well.

As to the Partial Acceptance, the concessions made there are not sufficient as justifications for approval of the transaction. No financial or structural protections are proposed in the Partial Acceptance. The petitioners would agree to divest Energy East's gas-fired generation, but that concession fails to cure or adequately mitigate vertical market power. The petitioners offer paltry monetary benefits that are not nearly adequate to compensate ratepayers for the risks attending the transaction. The proposal to invest in development of wind generation does not render an illusory benefit concrete.

In conclusion, the petitioners' efforts to distinguish these circumstances from those present in the KeySpan/Grid Order are unconvincing. As a result, the transaction should not be approved.[2]

ARGUMENT

I. The PSL §70 Approval Test

A. The Tangible Benefit Standard

Over the past decade, the Commission has issued numerous decisions establishing the standard entities seeking approval of an acquisition of an energy utility must meet to satisfy the PSL §70 public interest standard. Under those precedents, it is not enough to show that a merger or transfer transaction will not harm ratepayers. Instead, approval of such a transaction will be granted only where benefits outweigh detriments, after unacceptable risks are mitigated. Moreover, those benefits must be tangible and quantifiable. To ensure that these tangible benefits are properly realized, most large

[2] Staff has updated its Exhibits 107, 119-21, 123-25, and 128 in this proceeding. They are appended hereto, following the Attachments.

energy utility acquisitions in the past decade have been accompanied by a rate plan that ensures the monetized benefits are flowed through to the ratepayers of the acquired utility.

1. The Commission's Orders on Energy Company Transactions

The tangible benefit standard is now well-established. As the Commission decided in approving the 1999 merger between Con Edison and O&R, approval of such a transaction is warranted where "customers will receive immediate and tangible benefits from significant cost savings, rate reductions and new programs...."[3] To ensure those tangible benefits were realized, the approval of that merger was specifically conditioned upon setting a date for commencement of the distribution of the tangible benefits. To achieve this goal, synergy savings were allocated 75% to ratepayers and 25% to shareholders.

These benefits were deemed adequate, because the transaction posed no unacceptable risks to ratepayers. The utility's "financial integrity" was preserved and customers were shielded "from the risks associated with unregulated operation."[4] The merger, the Commission noted, raised only limited market

[3] Case 98-M-0961, Consolidated Edison Company of New York, Inc. and Orange and Rockland Utilities, Inc., Order Authorizing Merger (issued April 2, 1999)(Con Ed-O&R Order), p. 22.

[4] Con Ed-O&R Order, p. 22.

power concerns, and those were mitigated, resulting in the promotion of fair and effective competition in electric markets.

The framework established in the Con Ed-O&R Order is common to all large energy acquisitions and mergers approved in the past decade. The 1998 Brooklyn Union - LILCO merger was approved upon savings flowed through to customers as base rate reductions or credits, accompanied by new earnings sharing mechanisms. These public benefits were "undiluted by any new risk for customers or the public generally."[5] The 2000 Con Edison – Northeast merger was found satisfactory because it was accompanied by "a series of sizable rate decreases for customers starting immediately, which constituted "tangible and real reflections" of more efficient operations in a more competitive marketplace."[6] In that merger, the allocation of synergy savings was set at 65% to ratepayers and 35% to shareholders.

The 2001 approval of the acquisition of Niagara Mohawk by National Grid is also instructive. Again, the approval was warranted because a rate plan provided for savings resulting from the merger and "the write-off of a significant amount of

[5] Case 97-M-0567, Long Island Lighting Company and the Brooklyn Union Gas Company, Opinion No. 98-9 (issued April 14, 1998), pp. 6-7.

[6] Case 00-M-0095, Consolidated Edison Company of New York, Inc. and Northeast Utilities, Opinion No. 00-14 (issued November 30, 2000), p. 23.

stranded costs."[7] The 2002 merger between NYSEG and RG&E, where Energy East was formed as the holding company, also provided for savings flowed through to NYSEG ratepayers immediately in the form of a new rate plan. Moreover, that merger was also justified because NYSEG took concrete and substantial steps to promote the development of competitive markets.[8]

2. The KeySpan/Grid Order

The principles established in those Orders over the prior decade were reaffirmed in the KeySpan/Grid Order. There, the Commission emphasized it would not approve the merger unless it were demonstrated that "the savings to New Yorkers from the proposed acquisition are adequate to conclude that the transaction would be in the public interest."[9] Those tangible benefits would be flowed through to ratepayers through a rate plan completed and submitted for approval soon after the merger was approved. Moreover, unacceptable risks were avoided, by establishing financial protections to insulate the regulated utility operations from holding company financial difficulties

[7] Case 01-M-0075, Niagara Mohawk Power Corporation and National Grid Group plc, Opinion No. 01-6 (issued December 3, 2001).

[8] Cases 01-E-0359 and 01-M-0404, Energy East Corporation, New York State Electric & Gas Corporation, and Rochester Gas and Electric Corporation, Order Adopting Provisions of Joint Proposal With Modifications (issued February 27, 2002).

[9] KeySpan/Grid Order, pp. 115-16.

and requiring additional measures to address vertical market power.

The same issues that arose in the KeySpan/Grid merger are present in Iberdrola's proposed acquisition of Energy East. Therefore, to obtain approval of the transaction, the petitioners must show that unacceptable risks have been eliminated, by installing financial protections insulating the regulated utility subsidiaries from the ill effects of financial distress at the holding company level, and preventing the exercise of vertical market power. It then remains for the petitioners to show that there are tangible, monetary benefits to ratepayers, which will be flowed through to them in rates, that are sufficient to outweigh any remaining risks related to the transaction.

B. Petitioner's PSL §70 Interpretations

Notwithstanding the culmination of ten years' precedent in the KeySpan/Grid Order, the petitioners argue that Order is not directly comparable to Iberdrola's proposed acquisition. They claim that all of the electric and gas utility mergers the Commission has reviewed in the past decade are "synergy" mergers that create quantifiable benefits through the combination of utility operations. They argue that Iberdrola's acquisition of Energy East is a "non-synergy" merger that should be measured by a different standard (SM 933-34).

The petitioners, however, can find no support for their theory in the Commission's precedents on energy utility transactions. Seeking to justify their position, they point instead to precedent from the water utility industry as justifying their distinction. If categorized as a "non-synergy" merger under those precedents, they claim, immediate and quantifiable savings are not required (SM 983), and they need only show that "no harm" will come to utility ratepayers as a result of the transaction (SM 940).

The water utility cases the petitioners cite are irrelevant to this proceeding. The facts and circumstances confronting the water industry, and the character of water utilities, are completely different from the facts and circumstances confronting the electric and gas industry, and the character of electric and gas utilities.

In ignoring electric and gas utility transaction precedents, and instead attempting to rely upon the water industry precedents, the petitioners attempt to compare the two by hypothesizing that "the electric utility industry today faces its own set of challenges" (SM 941). Those challenges are in no way comparable to the circumstances the water industry and its utilities confront.

As petitioners admit, water utilities face a more difficult time than electric utilities in raising capital (SM

970). Those challenges are acute. As the Commission stated, “small water companies typically cannot attract capital and often have small cash reserves, or none at all.”[10] As a result, those utilities struggle to comply with health and safety regulations, including the federal Safe Drinking Water Act. The Commission therefore established a policy of pursuing consolidation of water companies through acquisition or merger, in an attempt to improve upon their ability to attract capital and provide service in compliance with health and safety regulations.

Given these general distinctions between the electric and water industries, petitioner Witness Meehan was unable to demonstrate that the water utility precedents he cited should guide the Commission in their review of the instant transaction involving Iberdrola and Energy East (Exh. 19, Response IBER-0246). In particular, he admitted he had not compared the circumstances of NYSEG and RG&E to that of any of the water utilities whose acquisitions were approved in the Orders he cited because he “didn’t feel it was necessary” (SM 971).

Such a comparison reveals deep and fundamentally-unbridgeable distinctions between the circumstances of large electric and gas utilities like NYSEG and RG&E and the water

[10] Case 93-W-0962, Acquisition and Merger of Small Water Utilities, Statement of Policy (issued August 8, 1994).

utilities. The decision upon which the petitioners primarily rely, the UWR Order, is instructive. There, the acquired water utility was not even earning its regulated rate of return.[11] In contrast, NYSEG and RG&E have consistently over-earned on their electric operations in recent years.

Moreover, the new parent described in the UWR Order could provide the New York regulated subsidiary with “enormous technological and financial assets to help the subsidiary, by supplying it with capital and expertise needed to meet its financial and infrastructure challenges.”[12] That outcome was expected by the Commission when it encouraged water utility consolidation. The Commission believed that the larger parent water entities would closely supervise and direct the activity of the New York water subsidiaries, thereby transmitting the value of their extensive expertise and greater knowledge to those subsidiaries. Under those circumstances, water utility ratepayers would receive substantial benefits from the acquisition transactions.

In contrast, Iberdrola repeatedly disavows any intent to so supervise the management of its new NYSEG and RG&E subsidiaries (SM 667-68, 704-05; Exh. 88, Response IBER-0009,

[11] Case 99-W-1542, United Water Resources, Inc. and Lyonnaise American Holding, Inc., Order Approving Stock Acquisition (issued July 27, 2000)(UWR Order), p. 9.

[12] UWR Order, pp. 7-8.

0060), creating another important distinction between the circumstances of the water utilities and this transaction. Moreover, NYSEG and RG&E are financially healthy entities standing alone (AM 631). They are fully capable of attracting the financing needed to meet their infrastructure needs, and possess the expertise needed to manage operations and meet infrastructure challenges. As a result, the circumstances in the UWR Order are not comparable to those here.

While the acquisition approved in the UWR Order has not yet unraveled, other water utility acquisitions have been less successful, falling even further from the circumstances of NYSEG and RG&E (at least so long as this transaction is not consummated). For example, the petitioners mentioned American Water Works Company (AWW). That utility holding company was first acquired by a foreign holding company entity in 2002.[13] Again, the hope was that consolidation would improve AWW's financial stability and enhance its ability to meet infrastructure needs. Such was not the case. By 2007, the foreign parent, known as RWE, was eager to divest itself of AWW, and received approval to do so.[14] Indeed, the parent was willing

[13] Case 01-W-1949, American Water Works Company, Inc. and Thames Water Aqua Holdings GMBH, Order Approving Terms of a Joint Proposal (issued November 27, 2002)(AWW I Order).

[14] Case 06-W-0490, American Water Works Company, Inc. and Thames Water Aqua Holdings GMBH, Order Authorizing Reorganization and Associated Transactions (issued July 26, 2007)(AWW II Order).

to make a substantial equity infusion into AWW, to facilitate its spin-off through an Initial Public Offering (IPO).

Notwithstanding the capital infusion, however, AWW experienced massive write-downs. It and its parent could not prevent the impairment of goodwill accumulated on its books as a result of prior merger transactions. As of March of this year, the IPO still had not been conducted. The outcome was a utility whose access to capital had been adversely affected. Without that access, the adequacy of service cannot be assured. Therefore, AWW's financial circumstances differ substantially from those of NYSEG and RG&E, so long as they avoid entanglement with a holding company such as Iberdrola, burdened with excessive goodwill, as discussed below.

The Commission in this proceeding should rely upon its numerous precedents over the past decade on electric and gas utility mergers, in particular the KeySpan/Grid Order. The water utility proceedings the petitioners cite are irrelevant, and should be disregarded, except to the extent they signal the financial risks excessive goodwill poses. Such excessive goodwill would be created if Iberdrola acquires Energy East.

C. The Intangible Benefits and Compliance With PSL §70

To conform to the existing policies on energy utility mergers and acquisitions, the petitioners must establish that the transaction will result in tangible benefits for ratepayers that are significant and outweigh the risks the transaction poses to ratepayer interests. Petitioners, however, offer no tangible benefits whatsoever. The benefits they did present are illusory or ephemeral.

Among the benefits accruing to ratepayers as a result of the transaction, the petitioners claim, are Iberdrola’s financial strength; its utility expertise; its commitment to customer service and maintaining reliability; its concern for energy efficiency and the environment; and, the promotion of economic development through the retention of utility jobs (SM 504-05). These alleged benefits are intangible, unquantifiable and speculative (SM 1191-92). None of the benefits is enforceable, and so all, even if extent, could vanish the day after the transaction is approved. As a result, they are not benefits sufficient to warrant approval of the transaction.

As discussed below, the Partial Acceptance works no material change in this analysis. The changes in position presented there are utterly inadequate to justify approval of the transaction. The value of monetary benefits offered is trivial in comparison to the risks the transaction poses to ratepayers, and the few, high-constrained conditions presented do not acceptably ameliorate those risks.

1. Financial Stability

Petitioners trumpet Iberdrola’s financial strength and stability, basing their claim in part on a contention that Iberdrola is one of the largest energy companies in the world, with a market capitalization of approximately $70 billion. They note that Iberdrola will fund the purchase of Energy East with an issuance of $4.5 billion of equity that has already been fully subscribed. After pointing out that Iberdrola’s credit ratings are currently higher than RG&E’s, they insist that the affiliation of NYSEG and RG&E with a parent of Iberdrola’s financial health is one of the most important benefits attending Iberdrola’s purchase of Energy East (SM 489-90).

Whatever the benefits that may attend Iberdrola’s current financial attributes, those characteristic are ephemeral. Iberdrola itself points out it was only the nineteenth largest energy company in the world in 2001 –- but that it had risen to the fourth largest such entity world-wide in 2007. Its charts detailing its rise through the size rankings of the world’s energy companies, however, also show other companies sank as fast as Iberdrola grew (Exh. 42, Strategic Plan, pp. 8-9). That Iberdrola’s financial size has risen rapidly is therefore nothing more than an indication that it could fall just as rapidly.

Indeed, financial stability is a risk of this transaction, not a benefit. The creditworthiness and other risks attending Iberdrola's proposed acquisition of Energy East far outweigh any benefit that might attend the financial strength it allegedly possesses at this particular moment. For example, while Iberdrola's credit ratings currently exceed those of Energy East, NYSEG and RG&E, that existing snapshot of comparative credit ratings could change rapidly. And the petitioners themselves admit that the direct benefit of Iberdrola's stronger credit rating for NYSEG and RG&E is not even quantifiable (SM 508).

The true risks of this transaction are detailed below. Iberdrola's current financial strength is no more a benefit than any other of the transient, unenforceable and unquantifiable non-monetary conditions it presents in its petition or its testimony. As a result, petitioners have failed to show that Iberdrola's present financial condition is a benefit to the ratepayers of NYSEG or RG&E sufficient to support a finding that the transaction is in the public interest under PSL §70.

2. Renewable Generation

Iberdrola claims its expertise in developing renewable generation, particularly wind generation, is a benefit to NYSEG and RG&E ratepayers (SM 466, 514-16). Iberdrola's involvement in renewables, however, is not a benefit connected to this transaction. It has no need to acquire T&D companies in order to participate in the development of renewable projects within New York.

The petitioners have been unable to establish any connection between the NYSEG and RG&E T&D utilities and Iberdrola that will facilitate the development of renewables projects. Indeed, the petitioners deny even the existence of the most rational connection -- that Iberdrola can offset federal production tax credits (PTC) on the generation of wind power against federal income taxes on the regulated earnings of NYSEG and RG&E (SM 520). Petitioners also deny that any synergy savings could be achieved by coordinating the operations of NYSEG and RG&E with the operations of wind projects. Indeed, the sole connection they establish is that Iberdrola will find comfort in the ownership of NYSEG and RG&E, and that level of comfort will enable it to expend resources on generation development in New York rather than other states.

This argument is illogical. If Iberdrola finds it necessary to own a T&D company in a State before it invests in wind development there, then it would not make such an investment anywhere in the U.S. where it does not propose to own a T&D company. But it is pursuing wind projects in States like Pennsylvania, Oregon and Texas, when it has no plans to own T&D utilities in those States. But it is not pursuing wind development in Maine, where it plans to own a T&D company (Exh. 41, Att. 19; Exh. 88, Response IBER-01315, IBER-0155).

Nor is it likely that Iberdrola will forego development of wind projects it finds profitable in New York, where the RPS incentive is available, for states where projects appear less profitable and there is no RPS incentive.[15] Indeed, other than the potential for offsetting PTCs against revenue, there is but one concrete benefit Iberdrola could potentially obtain from its affiliation with a New York T&D company -- that the T&D company will exercise vertical market power on Iberdrola's behalf.

Finally, Iberdrola claims that its wind development expertise is a benefit of this transaction because its ability to develop wind projects is needed if New York is to achieve its renewable generation goals (SM 519, 836). But New York can reach those goals without Iberdrola's assistance. As Petitioner Witness Hieronymus concedes, the wind project queue in New York is full and exceeds the ability of the State's T&D system to absorb more projects (SM 862). The loss of one wind developer

[15] To promote the development of renewable generation in New York, including wind power, the Commission has created incentives for the construction of renewable generation projects sufficient to reach a policy goal of generating at least 25% of New York's electricity from renewable resources. See, e.g., Case 03-E-0188, Retail Renewable Portfolio Standard, Order Approving Implementation Plan, Adopting Clarifications and Modifying Environmental Disclosure Program (issued April 14, 2005).

therefore will not detract from the State's ability to meet its wind development goals. The concern that DEC and NRDC express in asking if Iberdrola's expertise is needed to assist the State in meeting its wind development goals is therefore misplaced.

The exercise of vertical market power as a result of this transaction is more likely to hinder achievement of those goals than the absence of just one competitor. As discussed below, the combination in one company of the T&D operations of NYSEG and RG&E with the generation ownership and development operations of Iberdrola creates that vertical market power. In response to its exercise, wind project developers that would otherwise compete with Iberdrola could scale back their projects, or even withdraw from New York (SM 1161).

Iberdrola's ownership and development of wind generation is a detriment, and not a benefit of this transaction. New York State's renewable goals would be better served if Iberdrola ceased its pursuit of T&D company ownership and concentrated instead on building and operating economically-justified renewables projects (SM 1447-48), a line of business where it claims it possesses the expertise necessary to succeed.

3. The Other Intangible Benefits

The other benefits the petitioners posit -- Iberdrola's global expertise, promises of job retention, and commitment to service reliability (SM 489-92) -- are unenforceable and also could vanish as soon as the transaction is approved. The petitioners claim that potential benefits may accrue over time as NYSEG and RG&E can consult with Iberdrola and obtain from it information on best practices (SM 943). It promises to upgrade NYSEG and RG&E's performance through transmittal of its best practices.

Iberdrola's promises are not verifiable. To begin with, the petitioners cannot even identify which best practices Iberdrola intends to implement at NYSEG and RG&E. Nor can the value of Iberdrola's expertise, if any, be measured. And, there is no remedy if Iberdrola's global expertise fails to benefit NYSEG and RG&E, or if their reliability fails to improve, or if jobs are lost at the two utilities (SM 1191-92).

a. Best Management Practices

Iberdrola has not identified any best management practices that only it possesses. If, in fact, all it intends to do is serve as a source of otherwise-available best practices, there is no reason why NYSEG's presumably-competent existing management could not obtain that expertise from other sources, given their stated commitment to achieving sound management (SM 1192).

The petitioners also decline to explain how what expertise might be within Iberdrola's possession will be transmitted to the operating companies. Since Iberdrola repeatedly professes its reluctance to interfere with local management, it appears it will not order that the benefits of its expertise be implemented by NYSEG and RG&E. But Iberdrola cannot expect that its expertise will be absorbed by NYSEG and RG&E merely by Iberdrola's proximity in their neighborhood, especially since Iberdrola is headquartered in Europe, far from the NYSEG and RG&E service territories.

Similarly unconvincing is the petitioners' claim that reliability, safety and customer service will remain priorities for both NYSEG and RG&E after consummation of the proposed transaction (SM 513). Again, the petitioners decline to support their commitment with enforceable conditions. Without those conditions, nothing prevents them from allowing reliability and customer service to deteriorate (SM 1205-06). And, they seem to promise at most that they will maintain the status quo - - but continuation of the existing circumstances hardly constitutes a benefit.

Staff corrects the absence of conditions ensuring the preservation of reliability and service quality in the rate plan conditions it proposes below. But, because the conditions Staff proposes are a typical feature of rate plans that the Commission could require in any event, the unenforceable commitments petitioners present do not further improve upon service quality, and so cannot be considered a benefit of this transaction.

b. Job Retention and Economic Development

As to the promise to retain jobs, again, the petitioners transmogrify maintaining the status quo into a benefit, and make a promise that is ephemeral. Iberdrola has not made job commitments that extend beyond the day the transaction closes. It could hardly do so, as it must retain the flexibility to respond to changing circumstances in order to adequately protect the interests of its shareholders.

Moreover, the costs of funding utility jobs are included in the utility rates that NYSEG and RG&E ratepayers are billed. Because retaining jobs is a cost to ratepayers, it cannot also be treated as a benefit of the transaction to them. To the extent that utilities retain unnecessary employees, or overall employment levels are excessive, the result is not a benefit to ratepayers -- it is rates that are unreasonably high. It is well understood that high energy rates are a detriment to economic development, as employers leave the NYSEG and RG&E service territories for locations where utility prices are lower.

Iberdrola’s claim that retaining utility jobs is an economic development benefit is wrong for other reasons. When jobs are lost because utilities merge, usually most positions are eliminated through attrition, rather than through layoffs. Even where there are layoffs, the affected employees possess expertise that usually enables them to find other employment within New York. Indeed, other employers might be better able to avail themselves of a particular employee’s expertise, and generate greater growth from that expertise than would be achieved by a utility. As a result, even if job retention were achieved, economic development will not necessarily result.

c. Comparison to the NYSEG – RG&E Merger

The types of intangible benefits the petitioners posit are difficult to realize. In requesting approval of the prior NYSEG – RG&E transaction, for the formation of Energy East, those utilities presented a myriad of intangible benefits, including promises to maintain and improve upon the adequacy of services and reliability that are similar to the claims made here (SM 1195-96). Most of the NYSEG-RG&E commitments were not kept in any meaningful way (SM 1196-97).

An inquiry into the means for enforcing the intangible benefits posited in the NYSEG - RG&E merger is instructive. Those benefits are listed at pages 9-10 and 18-21 of the petition, dated March 23, 2001, the utilities filed in Case 01-M-0404. There, promises were made concerning the retention and location of offices and employees, representation on the Energy East Board of Directors, the formation of an advisory board, the continued operation of regional customer service centers, and the promotion of community and economic development.

The enforcement of those commitments, however, was to be accomplished through the Agreement and Plan of Merger setting up Energy East, attached as Appendix A to the petition. The promised benefits were set forth at §6.3, and §§7.9 - 7.21 of that Agreement. For example, §7.15 provided that, after the merger, Energy East would "increase the level of charitable contributions to, and community involvement with, Rochester, New York."

These conditions, however, did not prove enforceable. A few contained the seeds of their own destruction. For example, §7.9 provided that "there will be no involuntary reductions in workforce," but allowed for such reductions if they "become necessary." As to most other conditions, they disappeared as of the date the merger was effectuated. Buried in the Agreement, pages after the promises were made, was §10.1, which provided that the "representations, warranties, and agreements in this Agreement <u>shall not survive</u> the merger" (emphasis added).[16] Of the promises made at §6.3 and §7.9 - §7.21, only §7.16 was exempted from the general termination of obligations provided for at §10.1. And §7.16 merely provided for establishing an advisory board with no real powers.

[16] Agreement, §10.1, p. 50.

4. Conclusion

It appears that the petitioners here well understand that their intangible promises would carry little weight. Indeed, it appears the merger was delayed while Iberdrola and Energy East diverted substantial effort to cobbling together some benefits that could be made to appear publicly palatable (SM 1193). The intangible benefits therefore simply cannot justify approval of this transaction.

D. Future Transactions and §70

If Iberdrola were to acquire Energy East, and through it assume ownership of NYSEG and RG&E, any future transaction in which ownership of Iberdrola was sought could proceed only if the approval of the Commission were obtained. As the Commission decided in Opinion No. 97-8,[17] where a utility holding company is purchased by another holding company, the acquiring holding company will assume ownership of all of the original holding company's subsidiaries. That is the reality of such a transaction, and it therefore constitutes a transfer of the "works or system" of the utility subsidiaries, as that term is contained in §70.

Although Opinion No. 97-8 addresses telephone corporations and PSL §92 rather than §70, the rule adopted there

[17] Case 96-C-0603, New York Telephone Company et al., Opinion No. 97-8 (issued May 30, 1997), p. 13.

has been applied to electric corporations under §70. The Commission has held, since 2000, that PSL §70 jurisdiction extends to interests in holding companies upstream from New York affiliates that operate electric plant. As a result, whenever ownership of a holding company owning New York electric subsidiaries is transferred to another holding company, whether by stock purchase or otherwise, §70 adheres.[18]

This rule was recently reaffirmed in the 2008 Calpine Order.[19] It has also been applied to water company transactions.[20] Therefore, there can be no doubt that PSL §70 adheres to Iberdrola's proposed acquisition of Energy East.[21] If that transaction were consummated, the same rule would apply to any entity, whether organized in Europe or otherwise, attempting to acquire Iberdrola.

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[18] Case 00-E-1585, Sithe Energies, Inc., Order on Review of Stock Transfer and Other Transactions (issued November 16, 2000).

[19] Case 07-E-1385, Calpine Corporation, Declaratory Ruling on Review of Stock Transfer and Acquisition Transactions (issued January 22, 2008).

[20] Case 07-W-0178, Aquarion Water Company, et al., Order Approving Corporate Restructuring and Transfers Subject to Conditions (issued April 19, 2007).

[21] While jurisdiction adheres in all instances, the extent of review, and the conditions required for approval, vary depending upon the nature of the entity that is being transferred.

II. THE RISKS THE TRANSACTION CREATES

Iberdrola touts its financial strength as a benefit of the transaction. As discussed above, that financial strength could be ephemeral. Moreover, whatever Iberdrola's financial strength, it is far outweighed by the risks this transaction creates.

Subsuming NYSEG and RG&E into a holding company structure of Iberdrola's complexity and breadth creates holding company risk. That risk includes combining regulated and competitive entities in one structure; the complexity of the holding company structure itself; and, the incentive to overextend confidentiality treatment, to the detriment of the ratemaking process, that accompanies the competitive aspects and the complexity of the Iberdrola organization. Another risk attending Iberdrola's operations as a holding company is that it has become an attractive takeover target in Europe.

Iberdrola's acquisition of Energy East will create credit rating risk, because the NYSEG and RG&E credit ratings will become tied to that of the Iberdrola parent. If Iberdrola's ratings fall, the result could be falling ratings at NYSEG and RG&E. The financial health of NYSEG and RG&E would be adversely affected to the detriment of ratepayers.

There is affiliate risk. Iberdrola is a large and aggressive holding company that must successfully manage its many affiliates in navigating difficult and complex financial and economic challenges. Any one of those affiliates could engage in transactions that could harm the overall entity, and redound to the detriment of NYSEG, RG&E and their ratepayers. Moreover, Iberdrola's affiliates could also seek to do business with regulated entities like NYSEG and RG&E on favorable terms, again to the detriment of ratepayers.

The amount of goodwill on Iberdrola's books creates goodwill risk. If Iberdrola's income proves insufficient to support that goodwill, it could become impaired. Impaired goodwill leads to write-downs or write-offs, which could adversely affect Iberdrola's financial strength. Its declining financial health could then cascade down the corporate chain to harm the financial vitality of NYSEG and RG&E.

There is also capital structure ratemaking risk. The financial tie between Iberdrola and NYSEG and RG&E will create difficulties in arriving at the appropriate capital structure for setting NYSEG and RG&E rates. Techniques generally employed to overcome this type of difficulty are difficult to implement given the amount of goodwill on Iberdrola's books, its financial complexity, and its aggressive financial profile.

A. The Petitioners' Analysis of Risk

The petitioners protest that Staff's concerns are not "based on any factual substance or valid theoretical" analysis

(SM 1106). In belittling Staff’s risk analyses, however, petitioner Witness Makholm takes positions that are at odds with long-standing regulatory principles in New York and with the KeySpan/Grid Order. Witness Makholm claims, in effect, that events at the holding company level will not affect New York’s ability to regulate NYSEG and RG&E and protect their ratepayers from adverse impacts related to the holding company. He relies, in his analysis, upon the existence of a “regulatory compact” in New York. He also denies the efficacy of ring-fencing measures -- a prominent feature of the KeySpan/Grid Order.

The petitioners’ arguments are premised upon the assumption that traditional ratemaking powers are sufficient to protect ratepayers from those risks. The petitioners, however, misunderstand the nature and extent of traditional ratemaking, and the limitations inherent in that authority when dealing with an entity of Iberdrola’s complexity. Indeed, Witness Makholm would freeze regulation as it existed 30 years ago, at a time when transactions like Iberdrola’s acquisition of Energy East could not even have been contemplated. Much more than traditional ratemaking is required, and more modern approaches, such as ring-fencing, that satisfy more modern concerns have been developed. New York ratepayers should not be denied the protections from risk they deserve because petitioners take a retrograde approach to regulatory authority.

1. The Regulatory Compact

In support of his propositions, Witness Makholm relies heavily on the existence of the "regulatory compact" which, he says, enables the Commission to prevent degradation of the quality of service while guaranteeing investors a reasonable return on their investment (SM 1050-52). Based on his analysis of the regulatory compact, he asserts that Iberdrola's risks will not affect the Commission's ability to shield regulated subsidiaries from harm (SM 1058).

No such thing as the regulatory compact, however, exists in New York. It has been decided by the New York courts that the existence of regulatory compact of "provid[ing] safe and reliable service in return for prudent cost recovery" is "contradicted by the Public Service Law and have been repeatedly rejected by the courts."[22] Therefore, Witness Makholm's argument, that the regulatory compact somehow eliminates the concern that the risks attending the transaction will cause harm to New York ratepayers, is unsustainable.

2. Traditional Regulatory Powers

Witness Makholm attempts to buttress his argument that the Commission can adequately protect ratepayers from the adverse impacts of risk by claiming that existing regulatory

[22] Energy Ass'n v. Public Service Commission, 169 Misc.2d 924, 938 (Sup. Ct. Alb. Cty. 1996).

powers are sufficient to protect ratepayers from that threat. His argument amounts to a claim that the Commission need not concern itself with holding company operations, except for cross subsidies, because the Commission exercises control over the regulated subsidiaries sufficient to insulate their operations from the risks of the holding company parent (SM 1123).

This contention is absurd on its face. Utility subsidiaries have been dragged into bankruptcy by their parents, most recently in the case of Northwestern Corporation (Northwestern) and El Paso Electric Company (El Paso)(Exh. 114, Response IBER/EE IR No. 164, pp. 29-30).

In addition, the problems of the parent can cause substantial service degradations at the utility subsidiary, which can persist for long periods of time. The Commission's experience with Jamaica Water Supply Company (Jamaica) in the 1990's is instructive. When Jamaica's parent, EMCOR Group, Inc. experienced severe financial difficulties, the result was a long history of customer complaints directed against Jamaica's high rates and poor service quality. Eventually, Jamaica exited the water service business entirely.[23]

Luckily, qualified municipal entities were available to assume Jamaica's water service responsibilities. Even so,

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[23] Case 95-W-1176, Jamaica Water Supply Company, Order Approving Transfer (issued May 15, 1996); Case 92-W-0583, Jamaica Water Supply Company, Opinion No. 94-6 (issued March 2, 1994).

Jamaica's customers experienced years of poor service before its ultimate demise. NYSEG and RG&E ratepayers should not be left to suffer such a fate, even if it is assumed an entity could be found to assume their businesses after a fault on the part of the holding company parent wrecked their finances and weakened their ability to provide safe and reliable service.

3. Ring-Fencing

To prevent repetition of instances like Northwestern, El Paso and Jamaica, the concept of ring-fencing was developed. Even petitioner Witness Meehan recognizes the role of ring-fencing in providing for a "clear line of demarcation" between the regulated utility and the holding company" (SM 949). Moreover, Staff has explained the importance of the role of ring-fencing conditions in the KeySpan/Grid Order. And S&P has recognized the validity of the ring-fencing concept at least since 1999 (SM 1410-18).

Yet, Witness Makholm claims that ring-fencing is not a "term that's used in American regulation" (SM 1111). Instead, he claims that ring-fencing amounts to nothing more than traditional regulatory accounting and procedures (SM 1102-04). His position cannot be squared with the prevailing view of ring-fencing in "American regulation" or in the KeySpan/Grid Order.

A proper definition of the role ring-fencing plays in "American regulation" is set forth at Exhibit 108, p. 41, where ring-fencing is defined as the “prohibitions, reviews and/or conditions that will limit inter-company subsidies, cash transfers and other opportunities whereby a weaker parent/acquirer can impair the financial health of the regulated subsidiary.” Among the ring-fencing conditions suggested there are separation of utility and non-utility businesses, separation of corporate reporting, access to information the holding company supplies to bond rating agencies, controls on dividends and other money transfers between subsidiary and holding company, and ratemaking techniques for recognizing the impacts of the parent’s equity debt and equity structure on the subsidiary’s debt and equity structure.

Most importantly, ring-fencing conditions now standard in the utility industry include the “golden share.” Such a mechanism is created by inserting an independent director into the holding company structure between the parent and the utility subsidiary. The only function of that director is to prevent the parent company from filing the subsidiary into bankruptcy, if the filing is adverse to the public interest The “golden share” was a feature of the recent merger between Mid-American Energy Holding Company and PacifiCorp (Exh. 108, p. 44).

That Witness Makholm’s view of ring-fencing lacks merit is further evidenced by his analysis of the relationship between Portland General Electric Company (PGE), a regulated utility subsidiary, and its parent Enron Corporation (Enron). He maintains that traditional regulatory tools were sufficient to shield PG&E from the ill-effect of Enron's notorious financial malfeasance and resulting bankruptcy (SM 1102).

Witness Makholm, however, neglects to mention that a form of "golden share" was in place, along with other ring-fencing measures, at PGE (SM 1604-05). Even if the "golden share" was not exercised, its presence, and the fact that it could be exercised, formed the foundation for the application of other ratemaking techniques. Without the "golden share," the deployment of those techniques could well have been unsuccessful.

Finally, the Commission has expressed its view of ring-fencing by incorporating most of the techniques described at Exhibit 108 into the KeySpan/Grid Order. That Order sets restrictions on the cash flow and relationship between parent and utility subsidiary, establishes reporting requirements, and provides for a "golden share." Witness Makholm's position on ring-fencing is therefore at odds not only with the existing definition of the term in "American regulation," but also contradicts this Commission's specific prescriptions in the KeySpan/Grid Order. As discussed below, those prescriptions are appropriate here as well. Therefore, Witness Makholm's testimony is unsound and should be rejected in its entirety.

B. Holding Company Risk

The Iberdrola holding company is not in any way similar to existing Energy East holding company that owns the NYSEG and RG&E subsidiaries. Iberdrola's vast web of subsidiaries, sprawling across three continents, carries with it risks that dwarf those associated with the existing Energy East holding company.

Iberdrola provides regulated utility service to 22 million electric customers and two million gas customers world-wide. Notwithstanding this involvement in regulated delivery service, Iberdrola also owns hydro, combined cycle, renewable, cogeneration, thermal, coal and nuclear generation facilities. It operates subsidiaries engaged in marketing energy supply, energy trading, consulting, telecommunications, real estate, engineering, and construction (SM 1169-72).

Iberdrola engages in a variety of ownership techniques, including partnerships, special purpose entities (SPE) and joint ventures. While some of its interests are relatively straightforward, and wholly-owned, others are exceedingly complex, involving a web of affiliations and direct and indirect ownership interests. That complexity creates risk (SM 1349-51). Iberdrola is also constantly engaged in divesting and acquiring businesses. For example, it recently sold off 20% of its interest in its renewable subsidiary, Iberdrola

Renewables, through an initial public offering (SM 1283-85). This exceedingly complex holding company structure presents difficult challenges to the exercise of regulatory oversight.

1. Regulatory Compliance

In operating this vast array of subsidiaries, Iberdrola has experienced some problems with regulatory compliance. For example, since 2000, twenty-six interconnection complaints have been filed against Iberdrola-regulated delivery utilities operating in Spain. Moreover, in 2007, the Spanish anti-trust tribunal (known as CNE) fined Iberdrola $50 million for abusing its dominant position in generation in certain Spanish markets. Fines and sanctions have also been imposed on Iberdrola in Spain and Latin America for a variety of quality of service, breach of regulatory requirements and interruption of supply violations (SM 1176-78).

Moreover, in its Response IBER-0367, received March 13, 2008, Iberdrola provides another decision from CNE, detailing another Iberdrola abuse of its dominant position as a generation provider in Spain. The fine this time was $22 million, imposed after an investigation that took three years to conduct.[24] These problems with regulatory compliance are particularly troubling. If Iberdrola cannot ferret out anti-

[24] The decision is publicly available; Spanish National Competition Commission, Case 624105, Resolution (February 14, 2008).

trust affiliate abuse when operating both T&D subsidiaries and generation affiliates in Europe, it is unlikely to prevent similar abuses from occurring in New York, as discussed further below.

Moreover, Iberdrola is headquartered and organized in Spain. Communications difficulties could arise as a result. In the proceedings conducted on Iberdrola's acquisition in Maine concerning the Energy East affiliate located there, Iberdrola resisted translating Spanish documents into English. In this proceeding, it took 77 days for Iberdrola to respond to a Staff request for a translation. These delays could impede Staff's ability to monitor and investigate Iberdrola's operations (SM 1178-83). If this transaction is approved, enforceable conditions are needed to ensure that Staff can access, in English, the information necessary for assuring that Iberdrola will use fair business practices in New York, and that its operations and corporate relationships will be transparent to inquiries and investigations.

2. Unregulated Subsidiary Risk

The vast majority of Energy East's business subsidiaries are domestic utilities engaged in the provision of regulated service. Iberdrola, in contrast, owns subsidiaries engaged in a wide variety of domestic and foreign, regulated and non-regulated, businesses (SM 1354-55).

NYSEG and RG&E will form a much smaller proportion of Iberdrola's business than Energy East's business; the two New York operating subsidiaries constituted about 53% of Energy East's operations but will constitute only 9% of Iberdrola's total business (SM 1360). Obviously, the extent of regulatory influence over more than half of a business' operation is much more significant than when regulatory authority extends to less than 10% of a business' operations. As a result, the Iberdrola holding company will be less susceptible to regulatory authority and inquiry than the Energy East holding company was (SM 1357-58).

The incentive for improper cross-subsidization is much greater under Iberdrola's corporate structure than under Energy East's structure, because that risk grows when competitive entities are affiliated with regulated entities.
Energy East has few competitive affiliates. Iberdrola has many.

The temptation to shift costs from competitive companies to regulated companies is strong, because the operations of the non-regulated companies will seem more successful if costs are shifted to regulated companies, where they can then be recovered from ratepayers. If costs are shifted from one regulated entity to another, however, the incentive is less, because the regulated entity that sheds the costs will likely see its rates reduced as a result, thereby yielding less income. The competitive entity, in contrast, will continue to produce income at the same level after its costs disappear.

3. Complexity Risk

a. The Scope and Scale of Operations

The sheer complexity of Iberdrola's operations is another risk. Iberdrola's entire corporate organizational chart takes 15 pages to lay out (Exh. 20, Response IBER-0295). The bewildering array of subsidiaries and ownership relationships laid out in the chart speaks for itself as a vivid presentation of the vast reach and extent of Iberdrola's operations, and the scope and variety of its businesses. While Iberdrola seeks to limit inquiry into the complexity of its operations by demanding that the chart be treated as confidential, it shows that [redacted]

An inquiry into each of Iberdrola's businesses and the complex ownership interests involved would severely strain Staff's resources. The lack of operational detail that results if that inquiry is not conducted, however, can obscure the effect of the operations of Iberdrola's subsidiaries. Operational detail is useful as a screen to assist in detecting potential cross-subsidization of non-regulated entities by regulated entities. Such detail can also assist in gaining insight into the risks of the non-regulated operations, and the impact of those risks on the overall credit and financial stability of Iberdrola, as it affects NYSEG and RG&E finances. The lack of detail Iberdrola has provided obstructs those type of inquiries (SM 1181-82).

Moreover, even where Staff has inquired into Iberdrola's U.S. affiliates, it has been unable to ascertain their financial circumstances. Iberdrola's U.S. business operations alone are also exceedingly complex. After Iberdrola's 2007 acquisition of Scottish Power and PPM Energy, Inc., the U.S. subsidiary, Iberdrola operates over 100 affiliates in this country (Exh. 42, Response IBER-0060). Those interests include such diverse businesses as gas storage and transportation, renewable generation, and the sale of renewables attributes. The debt structure for all of these affiliates is of such complexity that it is also beyond the ability of Staff to monitor (Trade Secret (TS) Exh. 20, Response IBER-0187). As a result, Staff is unable to determine the risks of cross-subsidization among this vast web of subsidiaries. Indeed, it may be beyond Iberdrola's ability to monitor, [redacted]

[redacted] (Highly Sensitive Trade Secret Stenographic Minutes (HSTSSM) 4).

b. Gamesa and Community Energy

Other problems may arise from affiliation with unregulated subsidiaries. Two such problems already exist. As discussed below, Iberdrola owns partial interests in wind developers operating in New York, beyond its interest in the projects it intends to develop through its renewable subsidiary. These complex webs of affiliation are difficult to track, and expand upon the potential that Iberdrola will exercise market power.

Moreover, Iberdrola's aggressive campaign of acquiring subsidiaries has created a particularly acute risk of cross-subsidization and preferential treatment for its subsidiary over competitors. Prior to announcement of the proposed acquisition of Energy East, Iberdrola had also acquired Community Energy. That entity has an exclusive contract with NYSEG and RG&E authorizing it to market renewable energy attributes to NYSEG and RG&E customers (SM 1362-63, Exh. 42 Response IBER-0071S).

It appears that neither Energy East nor Iberdrola considered the impact of the proposed transaction on the contractual relationship between Community Energy and NYSEG and RG&E. Indeed, the exclusive marketing agreement NYSEG and RG&E

entered into with what is now an affiliate appears to violate existing codes of conduct at NYSEG and RG&E, which prohibit the provision of sales leads, the promotion of an affiliate and the giving of preferential terms to an affiliate (SM 1362-64). Nonetheless, the contract remains in effect (SM 1364). Moreover, [redacted] (HSTSSM 7). This sort of misbehavior involving affiliates is a risk that will only grow as Iberdrola grows.

The petitioners argue that the Community Energy contract is appropriate because it was entered into before Community Energy became an affiliate of NYSEG and RG&E. They also maintain that the existing codes of conduct present abuse of that relationship. As discussed above, those contentions lack merit. Therefore, the risk of abuses of the affiliation between Community Energy and the regulated utilities is a particularly stark example of risk to ratepayers Iberdrola's complex corporate structure poses.

4. Confidentiality Risk

Iberdrola's complex corporate structure and its many unregulated businesses encourage it to seek to shield its operations from public scrutiny through excessive use of confidentiality designations. In several instances in this proceeding, Staff agreed not to oppose confidentiality designations based on claims that such information, although public in the U.S., was considered confidential in Spain or Europe. Staff did not desire to prejudice Iberdrola's Spanish or European operations at a point in time when it had no interest in U.S. operations (SM 1183, 1280). If this transaction is approved, however, disputes over such confidentiality treatment can be expected, as Iberdrola resists application of U.S. confidentiality principles.

Particularly disturbing is Iberdrola's attempt to keep its corporate structure secret. Although Iberdrola made public versions of portions of its organizational chart (Exh. 42, Response IBER-0060), when the entire chart was sought, that was designated confidential. Such over-designations of confidentiality isolates Staff from interacting with other parties on important issues and restricts the public from participating fully in litigated proceedings (SM 1356-57). Staff can think of no reason why the entire corporate structure chart should be shielded from public scrutiny, except that its complexity might alert the public to the true nature of Iberdrola's vast and myriad corporate holdings.

Another disturbing designation is the submittal of the most recent credit quality metrics as confidential (TS Exh. 20, Response IBER-0286). This designation prevents the public from participating in a crucial issue in this proceeding -- the extent of Iberdrola's financial strength, its financial future and the effect of its finances on the financial health of NYSEG and RG&E. As a result, excessive confidentiality designations are another risk of Iberdrola's operations that is detrimental to the public interest.

C. Hostile Takeover Risk

Beginning in late January 2008, reports surfaced that Iberdrola had become the target of a hostile takeover by Electricite de France, S.A. (EdF). It was thought that EdF would partner with a Spanish construction company, already Iberdrola's largest shareholder, in making its bid (Exh. 58). Notwithstanding Iberdrola's protestations that reporting on takeover efforts is inherently speculative, there is little doubt that EdF, a massive French energy holding company, is pursuing Iberdrola. This hostile takeover poses risks to NYSEG and RG&E ratepayers, both in that Iberdrola may weaken itself in fending off the takeover or may be broken up into pieces if the takeover succeeds.

Staff inquired into the potential transaction, asking if Iberdrola had employed advisors to assist it in resisting the takeover. It also inquired into statements reportedly made by Juan Luis Arregui referring to EdF's hostile takeover bid. According to the reports, Mr. Arregui insisted he would oppose

EdF, and its partner “to the death,” complaining that the two plan to break up Iberdrola (Exh. 19, Response IBER-0361-64). It should be noted that Iberdrola’s own website states that Mr. Arregui is its Vice Chairman, and has been Chairman of Iberdrola’s affiliate, Gamesa (Exh. 59).

After the hearings ended, additional news reports surfaced. The Wall Street Journal (WSJ),[25] on March 21, 2008, described the proposed transaction in detail, as worth $100 billion, and as also including another Spanish utility besides Iberdrola. The WSJ believed that the deal was moving closer to fruition. Another report, at Forbes.com on March 21, 2008, noted that Iberdrola’s stock rose 1.2% with the re-election of Spain’s socialist government, which was viewed as more friendly to the EdF transaction than its political opponents.

On April 4, 2008, Forbes.com detailed ongoing developments in the hostile takeover effort. It described a Spanish court decision that compelled EdF to declare its intentions regarding Iberdrola, and EdF’s appeal of that decision. Surely, if EdF had no such intentions it would merely have so stated and avoided the expense of the appeal.

Iberdrola insists that its responses to Staff’s inquiry remain confidential. [redacted]

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[25] Petitioners’ counsel agreed that a New York Times or other publication that operate like traditional newspapers are more credible than an online publication (SM 1893).

[redacted] (Trade Secret Stenographic Minutes (TSSM) 8-11; TS Exh. 20, Response IBER-0361-64).] In light of Staff's original questions, and the subsequent news reports, and the recent Spanish court proceeding against EdF, Iberdrola's confidential responses to Staff IRs are not credible. The weight of reports subsequent to the hearing demonstrate that EdF is in fact considering a takeover of Iberdrola, albeit the fate of that effort remains highly uncertain.

The potential for a takeover could have an adverse impact on NYSEG and RG&E ratepayers in two respects. First, Iberdrola could pursue anti-takeover measures that would impair its financial health, to the detriment of its NYSEG and RG&E subsidiaries, if that acquisition went forward. Moreover, if EdF does succeed in bidding for Iberdrola, its purpose, as the reports indicate, is to break up the company. In that event, if NYSEG and RG&E had been acquired, a prompt spin-off can be expected. The unfortunate process described in the AWW II Order, <u>supra</u> and <u>infra</u>, where a foreign holding company finds it difficult to disengage from the U.S. market, could then be repeated to the detriment of NYSEG and RG&E ratepayers.

As a result, events in Europe add to the risks inherent in Iberdrola's acquisition of Energy East. They are another reason to reject the transaction, or to postpone its consideration until EdF's future role in Iberdrola's management becomes known.

D. Credit Rating Risk

The petitioners find a financial benefit in the credit ratings Iberdrola has obtained from the major rating agencies which, they note, are higher than the ratings NYSEG and RG&E have achieved. The petitioners list those ratings for Iberdrola as A3 by Investor's Service (Moody's) and A- by Standard & Poor's (S&P), both with stable outlooks, and A by Fitch, Inc. (Fitch), with a negative outlook. In comparison, Energy East is rated Baa2 by Moody's, BBB+ by S&P, and BBB by Fitch, all with negative outlooks. The petitioners interpret these statistics as demonstrating that Iberdrola's acquisition will open to NYSEG and RG&E greater access to capital at a lower cost, supporting their provision of high-quality safe and reliable utility service. Staff disagrees.

1. The Effect of Equity Funding

Whatever the advantage Iberdrola may currently hold over Energy East in comparative credit ratings, the risk that Iberdrola will not be able to maintain its current rating is substantial. Indeed, the proposed transaction could harm the fiscal health of both Iberdrola and of the NYSEG and RG&E

subsidiaries it would acquire, notwithstanding that Iberdrola will fund this transaction with equity rather than debt.

Although pre-funding its acquisition of Energy East through early placement of an equity issuance was the most fiscally-prudent avenue for Iberdrola to finance the transaction, the acquisition will nonetheless add approximately $3.7 billion of Energy East's existing debt to the Iberdrola balance sheet, if the transaction were to close (SM 1278, Exh. 100). Moreover, much of the benefit of using equity as the financial tool for accomplishing these transactions is squandered, because the acquisition creates $2.9 billion of goodwill on Iberdrola's balance sheet (including the goodwill Energy East currently carries), out of a total purchase price of $4.5 billion. As a result, the pro forma post-acquisition capital structure of Iberdrola will be set at 42% equity and 58% debt, with goodwill representing 46% of the equity capital (Exh. 100). If the goodwill were impaired and had to be written off, the equity ratio would fall to 34%, with the debt ratio rising to 66% (SM 1323).

Even the 58% debt figure is inconsistent with Iberdrola's current A rating from S&P. That rating agency, in 2004, revised its financial guidelines and assigned business profile scores to U.S. utilities (Exh. 102). The S&P report shows that a utility business with a profile rating of 5, which would be Iberdrola's rating, and a pro forma debt ratio of 58%, Iberdrola's ratio after the transaction, would be consistent with a BBB bond rating –- which is Energy East's current rating from S&P. Such a rating would also be consistent with another analysis S&P conducted of power company ratings in 1998 (SM 1454, Exh. 103). And, this implied rating presumes that goodwill is not impaired. Significant impairment could reduce Iberdrola's rating to junk bond status (SM 1282).

2. Pressures on Iberdrola's Credit Ratings

Iberdrola's credit rating has already been downgraded one notch by S&P and Moody's after its petition for approval of the transaction was filed (SM 1283), albeit a "negative outlook" for the company was rescinded after it successfully conducted the IPO for its renewable subsidiary. The transaction itself may cause further downgrades. As a result, the benefit of the financial strength that Iberdrola claims it will bring to NYSEG and RG&E by virtue of its credit rating may be fleeting.

Trends indicate that Iberdrola's credit ratings may be on the decline. Its bond rating has fallen from AA- to A- over the past six years (Exh. 89, p. 2). That decline has moved in tandem with its declining equity ratio, which has been reduced from 63% equity ten years ago (Exh. 89, p. 1), to the 42% equity ratio expected once the transaction is consummated. Presumably, during this period, Iberdrola was promising to maintain its strong credit ratings, just as it claims now.

Other uncertainties in the future could adversely affect Iberdrola's financial strength. Iberdrola has presented a Strategic Plan that describes its ambitious program for growing its business in the future. As described in the Strategic Plan, it is embarking on a $38 billion investment program (Exh. 42, Exh. 70, p. 2). If fulfilling the investment program requires Iberdrola to incur substantial amounts of debt, then its ratings could be downgraded (Exh. 70, p. 12). Future acquisitions of businesses not presently contemplated in the Strategic Plan would further stress Iberdrola's financial metrics (SM 1295).

S&P notes that Iberdrola has pursued opportunities outside of its Strategic Plan, if it considered them attractive, even though those future acquisitions might dilute its financial strength (Exh. 101, p. 6). S&P also reports that Iberdrola continues to increase dividends in the midst of what is an ambitious investment strategy (SM 1295). Maintaining such a dividend and seeking to constantly increase it imposes additional pressure on Iberdrola's financial metrics (SM 1295).

When, as detailed in Exhibit 101, S&P downgraded Iberdrola, it expressed the view that its financial profile and credit protection measures were no longer compatible with an A rating. That downgrade reflected the impact of Iberdrola's acquisition of Scottish Power plc (Scottish Power) and its plans for future growth (SM 1284-85). At that time, S&P also listed other factors affecting Iberdrola's risk profile, including: increasing competitive pressures in electricity markets; exposure to pool price volatility; and exposure to volatile Mexican and Brazilian energy markets. When these risks are added to the weakening of the financial profile following acquisition of Scottish Power, and the ambitious growth program, S&P did not foresee an upgrade in Iberdrola's credit rating in the intermediate term. Instead, it suggested scenarios that would produce downgrades quickly in Iberdrola's credit rating if events proved unfavorable to the company.

Moody's, in late 2007, also issued a report carefully evaluating Iberdrola's future (Exh. 104). On page 2 of its report, Moody's took note of increased business risk Iberdrola faces, stating that:

> This risk assessment factors a degree of integration and execution risk as the company has expanded into new markets in which it has had less prior experience, and, in addition, the group has ambitious growth targets which may not be achieved if operating conditions become more difficult.

Although Moody's viewed Iberdrola's rating outlook as stable, it also warned that its credit ratio metrics were positioned at the lower end of the A-3 rating category that Moody's considered appropriate. Moody's concluded that, if Iberdrola failed to achieve its growth targets or if regulatory or pricing developments were adverse to the company, those ratios would fall under additional pressure (SM 1293).

3. Effect on NYSEG & RG&E

Notwithstanding the credit ratings and financial strength that Iberdrola touts, the announcement of its acquisition of Energy East did not result in any positive impact on the ratings of the T&D utilities (SM 1062). Instead, the rating agencies expressed concern over NYSEG and RG&E’s financial metrics (Exh. 90). Further clouding their outlook were uncertainties concerning Energy East’s ultimate capital structure, and the extent to which the proposed transaction would affect existing Energy East dividend policies. Given these concerns, the petitioners have been unable to demonstrate that the affiliation of NYSEG and RG&E with Iberdrola would yield tangible credit rating improvements for either T&D subsidiary (SM 1299, Exh. 19, Response IBER-300).

Nor is Iberdrola’s access to capital markets, even as evidenced by the success of its issuance of equity for funding this transaction, a benefit to NYSEG and RG&E. The existing parent of those two T&D utilities, Energy East, already has ready access to capital markets. Indeed, Energy East recently accessed equity markets, issuing 10 million shares in March 2007. Thus, Energy East has sufficient access to capital markets without any assistance from Iberdrola. Since the assistance is unneeded, it is not a benefit of the transaction.

Finally, one recent event indicates that the investment community does not consider Iberdrola's acquisition as an improvement to the credit quality of NYSEG and RG&E. On November 29, 2007, NYSEG went to the capital markets with a debt issuance. In those markets, the debt was priced at 225 basis points above the 10-year Treasury rate (SM 1308). Utilities comparable to NYSEG were able to issue comparable debt for 33 basis points less than NYSEG obtained (SM 1308). If capital markets believed that Iberdrola's financial strength would contribute to NYSEG's financial strength, it would have been able to obtain a more favorable rate for its debt issuance.

E. Petitioners' Credit Ratings Arguments

Disputing Staff's analysis, the petitioners claim that credit ratings will remain strong and that Iberdrola's financial strength will consequently benefit NYSEG and RG&E. The petitioners also present their Witness Fetter and Witness Makholm, who claim that Staff's analysis is conceptually flawed. Witness' Fetter's position is dependent upon undue faith in credit rating agency performance and unrealistic optimism over Iberdrola's financial circumstances. Witness Makholm's argument is rhetorical rather than substantive.

While acknowledging that S&P and Moody’s have downgraded Iberdrola, the petitioners maintain that those rating agencies’ current outlook for Iberdrola’s ratings are stable. They claim that Iberdrola’s most recent financial results demonstrate that it is on track to retain its current credit ratings, and that credit ratings agencies reflect in their analyses Iberdrola’s Strategic Plan, its acquisition of Scottish Power, and its proposed acquisition of Energy East. The petitioners view the likelihood that Iberdrola will be downgraded as remote.

Iberdrola’s A ratings take on even more importance and significance at a time of turmoil in capital markets, the petitioners assert, because higher-rated companies will gain superior access to capital in such troubled times. The petitioners buttress their argument by noting that the difference in spread between A and BBB rated companies has increased to 35 basis points.

The petitioners also announced that Iberdrola’s growth and net operating profits have increased by over 20% during the most recent annual period. They compare the stock prices of both Iberdrola and Energy East from January 2004 through January 2008, and claim that Iberdrola’s superior performance illustrates equity markets’ confidence in Iberdrola, as superior to their confidence in Energy East. These indicia of its financial strength, the petitioners stress, have been achieved through the consummation of the Scottish Power acquisition and the announcement of the Energy East transaction.

Even if Iberdrola were downgraded, the petitioners contend, a downgrade would not harm NYSEG or RG&E. They believe that, because Iberdrola's ratings are one to two notches higher than Energy East's, there is room for a downgrade of Iberdrola without its rating falling below those of Energy East.

Finally, the petitioners dispute Staff's argument that the proposed transaction has had a negative impact on NYSEG's recent financing. They believe that the differential between the rates NYSEG achieved on its debt issuance and the rate its peers achieved is attributable to the proxy group selected for making the peer comparison. They conclude the differential is unrelated to the transaction.

1. Iberdrola's Alleged Financial Strength

The petitioners' arguments are unconvincing. The petitioners base their representations of Iberdrola's strength in part on anecdotes, especially as presented in their Strategic Plan, that understandably reflect their pride in Iberdrola's recent growth and accomplishments. Unfortunately, as the widely-known disclaimer states, past performance does not necessarily guarantee future results. The petitioners' anecdotes regarding Iberdrola's recent financial successes, and what are only hopes for future successes, are not a reason for approving this transaction.

Notwithstanding their optimism, Iberdrola's capital structure must still support $13.4 billion in goodwill, representing 46% of its equity. Because of that goodwill, Iberdrola cannot be considered well-capitalized and the risks it presents to the creditworthiness of NYSEG and RG&E remains.

Nor does Iberdrola's size necessarily translate into creditworthiness. It boasts of its rise in comparison to the size of other energy companies between 2001 and 2007, but its own charts show that, while it and some other companies were growing rapidly, others were declining just as rapidly (Exh. 42, Strategic Plan, pp. 8-9). Its growth and size also did not prevent its decline in credit rating from AA- to A- during the period from November 2001 to December 2007, or the decline in Moody's rating from A1 to A3 over the period from November 2002 to December 2007. Indeed, the consolidation of smaller energy utilities into larger energy utilities since the early 1990's has been accompanied by a decline in the credit quality of the group to the BBB category (Exh. 109). Bigger is not better, for either Iberdrola or the electric utility industry generally.

2. Credit Rating Metrics

The petitioners criticize Staff's analysis of Iberdrola's capital structure as more consistent with that of a

BBB rated utility than an A rated utility. Witness Fetter believes rating agencies, and investors, are primarily concerned that the issue of debt be able to pay interest and principal when due. He maintains that this focus on cash flow explains why, even after Energy East successfully issued ten million shares of common equity in March 2007, the rating agencies did not revise their negative outlooks for the company. He also maintains that both S&P and Moody’s are comfortable with Iberdrola’s existing debt level. Staff, he says, is overly focused on the effect of capital structure debt and equity ratios on credit ratings. Witness Fetter buttresses those arguments with a claim that Staff’s analysis is based on dated materials, which have been superseded by S&P’s more recent approach to ratings, as presented in Exhibit 66.

a. The Risk Profile Analysis

Exhibit 66 updates only S&P’s approach to business risk and financial risk profile ratings as presented at Exhibit 102. There, business profiles were rated on a numeric scale of 1 to 10, with 10 as the weakest. S&P has replaced that system for evaluating business risk with five verbal categories, ranging from Excellent to Vunerable. Utilities and their holding companies that are focused on regulated businesses, however, almost always fall into the upper range of the category, at Excellent or Strong business risk profiles. As a result, any regulated utility will be seen as less risky than most U.S. companies, because they are below average in risk. That S&P's views regulated companies as less risky than unregulated companies is not surprising.

But it is reasonable to assume that holding companies like Iberdrola that are less focused on regulated utility operations, because engaged in a greater number of competitive businesses, will be ranked only Satisfactory on business profile risk instead of Excellent or Strong. Such a ranking would be consistent with Iberdrola's previous business risk profile ranking of 5 out of 10.

Moreover, S&P's new system also ranks financial risk profiles by verbal category, from Minimal to Highly Leveraged. Applying this framework to Iberdrola should result in a financial risk categorization as Aggressive.

When a Satisfactory business profile is combined with an Aggressive financial profile, Exhibit 66 shows that the applicable rating is BB+. As a result, S&P's new credit parameters seem to place Iberdrola at best in the BB+ to BBB range. BBB, of course, is the existing rating of NYSEG and RG&E. As a result, Iberdrola would not contribute at all to the financial health of NYSEG and RG&E as utility subsidiaries.

b. <u>FFO Metrics</u>

Witness Fetter also contends that Funds From Operations (FFO) interest coverage and FFO total debt are two important metrics of credit rating that Staff has disregarded (SM 748). He maintains that Iberdrola’s metrics in those categories are commensurate with an A rating (SM 757).

Moody’s, in 2005, prepared a rating methodology for global regulated electric utilities (Exh. 114, Response IBER/EE IR No. 164). There, Moody’s presented its assessment of cash flow metrics. Moody’s also, in February 2008, published its assessment of financial indicators for Iberdrola (Exh. 70). In that exhibit, it identified Iberdrola’s FFO interest coverage ratio as 4.3X and its FFO net debt ratio as 18.9%.

When the metrics at Exhibit 70 are compared to the standards at Exhibit 66, however, the result is not definitive. The possible credit ratings that result fall in the range from A to Baa. But more recent confidential data shows that [redacted]

[redacted] (TS Exh. 20, Response IBER-0286).

Attachment 1 hereto sets forth comparisons of Iberdrola's current metrics to the S&P and Moody's rating criteria. These comparisons justify the concern that Iberdrola will not be able to maintain is current credit rating.

c. The Ratings Picture

It is clear that Witness Fetter has painted an overly-optimistic view of Iberdrola's risk. Under S&P's older methodology, Iberdrola's metrics are not consistent with an A rating (SM 781-82). Moreover, Moody's most recent analysis flatly concludes "the financial risk profile for Iberdrola is expected to stay weakly-positioned for its rating category." (SM 783-84). The remainder of Witness Fetter's testimony consists of selective quotation from various financial reports taking a rosy view of Iberdrola's credit ratings (SM 756-67, 792-95). They are contradicted by Staff's analysis of statements from the same reports warning of the risks that Iberdrola faces (SM 1284-97).

3. The Value of Credit Rating Reports

Witness Fetter also overly relies on the value of credit reports generally as indicators of future performance. He is critical of Staff's statement that credit ratings are snapshots in time of a company's existing circumstances that may change rapidly in the future (SM 751-52). It is widely known, however, that rating agencies have failed to timely warn the public of several instances of rapid corporate demise. Recently, for example, the rating agencies missed the sub-prime mortgage debacle instead of preventing it.

An investigation into the rating agencies' failure to timely apprise the public of the risks associated with sub-prime mortgages has been launched (Exh. 71, pp. 1-2). Notwithstanding abundant indications that their ratings of sub-prime mortgage securities were substantially overstated, the rating agencies continue to rate those securities highly throughout 2006. Ignoring the indications, however, caused the rating agencies to issue predictions of the performance of those securities that were soon proven completely and utterly wrong. In fact, the agencies eventually were forced, belatedly, to make rapid ratings downgrades by as much as five notches, from investment grade to junk, in a very short period of time (Exh. 71, pp. 6-8). Therefore, credit ratings can change rapidly and present financial strength is not a guarantee of future financial performance.

4. The Harsh Regulation Claim

Petitioner Witness Makholm also argues that Staff's analysis of credit quality is misplaced. He claims that the Commission's "harsh treatment" of its regulated companies is the reason the credit rating agencies have a negative outlook for NYSEG and RG&E (SM 1060). Any problems the credit rating agencies have with this transaction, he contends, arises out of the concern that the Commission will attempt to extract excessive concessions from the petitioners in order to obtain approval of the transaction.

Witness Makholm also claims that this Commission has awarded rates of return that are below the rates of return set in other states (SM 1066). The chart upon which he relies, however, is misleading. The rate of return numbers presented there are not sorted into categories for litigated proceedings and settlement proceedings. Rates of return awarded in settlements are generally higher than those in litigated proceedings (SM 1113-14).

Other factors may also affect the rates of return states set. For example, New York reduces risks for its utilities through means such as revenue decoupling mechanisms and provisions for deferral of unexpected expenses. Utilities in other states may not be able to avail themselves of these risk-reducing mechanisms, and so must be compensated with higher rates of return. Therefore, the comparisons Witness Makholm relies upon should carry but little weight.

As of the date of the hearings, no rating agency had downgraded any New York utility because of a regulatory decision in the past three years. As a result, Witness Makholm lacks support for his claim that rating agencies view the Commission negatively.

After the hearings closed, however, the Commission issued a rate decision for Con Edison that did result in the downgrade of that utility by Fitch and S&P.[26] Even as downgraded, however, Con Edison's ratings remain above those of NYSEG and RG&E and so that utility's credit quality remains acceptable. Moreover, Moody's declined to downgrade Con Edison, S&P proclaimed an outlook of stable after the downgrade and only Fitch was critical of the Commission. Any of the latter's critical comments are more than balanced by the traditional approach taken by S&P and Moody's. As a result, there is no evidence that this Commission will take actions leading to the downgrade of NYSEG and RG&E below BBB, just as there is no evidence that Iberdrola will raise their ratings above that level.

F. Goodwill Risk

The post-acquisition capital structure for Iberdrola will reflect approximately $13.4 billion in goodwill. Although Iberdrola has promised not to record that goodwill on the books of NYSEG or RG&E, a prohibition against taking that step is

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[26] Case 07-E-0523, Consolidated Edison Company of New York, Inc. – Electric Rates, Order Establishing Rates For Electric Service (issued March 25, 2008)(Con Ed Electric Order).

absolutely required under Commission precedent and so is not an option (SM 491). But keeping the goodwill off the books of NYSEG and RG&E is not sufficient to protect their ratepayers from its ill effects. The presence of the goodwill on the books of Iberdrola and Energy East will mask their true credit quality, and the impact of those credit quality risks on NYSEG and RG&E.

1. Goodwill Write-Downs

A write-down or write-off of Iberdrola's goodwill is likely in the long term (SM 1322). In contrast to Iberdrola, regulated utility assets comprised the bulk of Energy East's assets. Investments in regulated plant are recovered on the basis of their original cost through depreciation and a return on the investment (the rate of return). Regardless of the price of the sale when a regulated asset is acquired, the amount collected in rates for those assets remains based on original cost. As a result, the cash flow of the utility is divorced from the cost of goodwill (SM 1312-25).

While this approach to ratemaking protects ratepayers to some extent, it has the effect of requiring the parent entity carrying the goodwill to support it without relying upon cash flow from the regulated utilities. This creates a risk of financial problems for the parent when the goodwill asset is inevitably deemed impaired and written off to common equity (SM

1316-19). As discussed above, if Iberdrola's goodwill is written off, its equity ratio will fall to 34%, to cause its ratings to fall below investment grade (SM 1323).

In the short run, a write-down of Iberdrola's goodwill may seem unlikely, because it has performed capably in 2007 and its earnings continue to grow (SM 500, 1324). Unfortunately, the risk of impairment to goodwill will increase with the passage of time, as the company is exposed to macro-economic events. A recession or other adverse event could limit Iberdrola's earnings, and, if earnings fall, write-downs could occur. A series of write-downs would impair Iberdrola's access to capital.

2. The AWW Experience

Recent experience demonstrates that goodwill impairment can occur, and threaten service adequacy at a regulated utility. In the AWW II Order (supra), the failure of an international utility holding company parent, known as RWE, to solve the problems of its New York water company subsidiary, known as AWW, became evident, in that the parent sought to rid itself of the presumably under-performing subsidiary. The parent was even willing to make an equity infusion to support the IPO that will enable it to escape from the subsidiary and exit the New York utility business. Unfortunately, that IPO has yet to take place (Exh. 81).

Instead, the RWE parent has been compelled to repeatedly write-off impaired goodwill at AWW, in the amount of nearly $400 million in 2005, over $225 million in 2006, and over $500 million in 2007 (Exh. 81, p. 23 of 222). The RWE parent was forced to conclude that "further recognition of impairments of a significant portion of goodwill would negatively affect our results of operations and total capitalization, the effect of which could be material and could make it more difficult for us to secure financing on attractive terms and maintain compliance with our debt covenant." (Exh. 81, p. 24 of 222).

In other words, the goodwill impairments could threaten safe and reliable service, as AWW, the New York water utility will be unable to secure the financing necessary to provide that service. Moreover, bankruptcy for failure to meet debt covenant requirements is not out of the question. Notwithstanding the petitioners' protestations, goodwill therefore can seriously harm a regulated utility.

3. Iberdrola's Goodwill Risk

The threat goodwill poses in this transaction is more substantial than posed in other recent energy utility acquisitions. In those cases, synergy savings were realized and at least some portion of the savings flowed to the utilities' shareholders. In those circumstances, the cash flow from the shared savings could support the goodwill, and the goodwill balance would reflect the present value of the future savings (after tax). Here, however, the petitioners vociferously deny that any synergy savings will be realized. As a result, the goodwill is unsupported (SM 1320).

Moreover, future transactions could exacerbate the ill effects of goodwill. Goodwill is already created on the books of Energy East from its formation as the holding company for NYSEG and RG&E. If Iberdrola were to acquire Energy East, second generation of goodwill would be created. If Iberdrola were then acquired by another entity -- a real possibility, as discussed below -- then third generation goodwill would be created. With each generation of goodwill, proportionately fewer income-producing assets will carry the load of supporting comparatively more goodwill. Adding generations of goodwill creates ever-increasing financial risk and is not sustainable in the long run.

Iberdrola's acquisition of Energy East therefore poses substantial risk to the credit ratings of NYSEG and RG&E. Affiliating with Iberdrola is not a benefit of the transaction.

G. Petitioners' Goodwill Arguments

In disputing Staff's analysis of goodwill, the Petitioners also claim that Iberdrola can support its goodwill. As a result, they claim goodwill risk is minimal.

1. Risk of Goodwill Impairment

Witness Fetter believes the risk of goodwill impairment is small. Continuing his focus on cash flow, he maintains that so long as Iberdrola's strong operational performance continues to create strong cash flows, goodwill impairment is unlikely. He claims that potential for goodwill impairment is not even mentioned by credit rating agencies in their analyses of Iberdrola and Energy East.

Again, Witness Fetter is overly optimistic. Existing cash flows are no guarantee of future cash flows. If the risks Iberdrola faces are borne out, the result would be reductions in its cash flow. The reasons for Witness Fetter's optimism would then disappear. The reverse of his cash flow analysis would assert itself with a vengeance -- lack of cash flow would cause goodwill impairment, which would lead to a crippling of Iberdrola's financial health.

2. Rating Agencies and Goodwill

Petitioners are incorrect in asserting that rating agencies are unconcerned with the role of goodwill in the risk profile of a company. S&P reports that its assessment of goodwill is tied to the synergies that can be realized from an acquisition. If those synergies do not produce the expected savings and return on investment, then S&P questions the value of the goodwill. In that event, S&P will assess the credit of a company with large amounts of goodwill by deducting that goodwill from the leverage calculation to arrive at a measure of leverage that is tangible (Exh. 86, pp. 3-4).

The absence of synergy savings in support of goodwill is exactly the circumstances that Iberdrola faces, and that S&P warns against. Without savings to support the goodwill, Iberdrola may experience a financial shortfall in supporting that goodwill, which is attributable to the premium it paid for Energy East. Indeed, even an exceptional return, in the amount of 12% on Energy East's regulated equity, would enable Iberdrola to realize only a 4% return on its investment in Energy East.

3. Goodwill and the Pursuit of Earnings

Witness Makholm opines that Staff's goodwill concerns are misplaced (SM 1046-47). He maintains goodwill does not change a holding company's incentives for extracting earnings from a regulated utility subsidiary.

Witness Makholm is wrong. Indeed, in light of the experience of AWW described above, Witness Makholm's claim that the presence of goodwill in connection with the Iberdrola acquisition is a routine event that creates no new incentives is outlandish. Iberdrola will likely need excessive earnings from Energy East to support the goodwill. To achieve those excessive earnings, it must cut costs. When it does so, risks to the preservation of safe, adequate and reliable service will inevitably arise. That goodwill creates an incentive to extract more earnings from Energy East should not be denied, and the adverse affect that pursuit of those earnings could have on ratepayers is a reality.

That Iberdrola carries $13.4 billion of goodwill on its books creates a risk to it, and to the credit quality of NYSEG and RG&E. The goodwill created in this transaction is not supported by any synergy savings, at least according to the petitioners, and so the goodwill is supported only so long as Iberdrola can maintain its growth and cash flow. While it is speculative to predict when goodwill might be written down, or how much of an impairment might occur, if Iberdrola cannot maintain its organic and external growth, then impairment of goodwill becomes a real possibility.

H. Capital Structure Risk

1. Use of a Consolidated Capital Structure Is Appropriate

Staff's testimony established that it was appropriate and prudent to use Iberdrola's pro forma consolidated capital structure as the ratemaking capital structure for NYSEG and RG&E, given the Commission's preference for this approach (SM-1326). The Commission declared in Case 28947, Opinion No. 85-15 (issued September 26, 1985), p. 47, that: "When the utility itself is a subsidiary, as is National Gas Distribution Corporation, it is proper, at least in the first instance, to assume that the parent corporation's cost of capital is also the subsidiary's because it is the parent that raises capital" (SM-1326-27).

More recently, in the NYSEG Electric Order,[27] the Commission reiterated its policy of using the parent's capital structure as the basis for setting a utility subsidiary's rates. The Commission stated it:

> requires financial separation and insulation for New York subsidiaries for them to obtain ratemaking recognition for their stand-alone capital structure. The record in this case does not show that Energy East has implemented any corporate restrictions or standards to separate NYSEG's capital structure from its own. This lack of separation precludes us from relying on anything other than the consolidated capital structure for ratemaking purposes (SM 1327).

In this case, Iberdrola has not proposed to implement ring-fencing conditions that are adequate to separate Energy Easts' capital structure from Iberdrola's own. This lack of separation would preclude the Commission from relying on anything other than the consolidated capital structure in order to set rates for NYSEG and RG&E.

2. Staff's Subsidiary Adjustments Were Appropriate

Staff's testimony established that the Commission has identified specific ways to treat the unregulated assets in a utility's consolidated capital structure. In Case 28947, the

[27] Case 05-E-1222, New York State Electric & Gas, Order Adopting Recommended Decision With Modifications (issued August 23, 2006).

Commission stated: “That is not to say, however, that a parent’s capitalization would not be adjusted, were we to find that the parent’s investments in unregulated subsidiaries required it to build a capitalization that was less leveraged than the utility subsidiary’s stand-alone capitalization needed to be” (SM 1328-29).

The Commission has long employed a subsidiary adjustment mechanism to develop the appropriate regulated capital structure from the capital structure of a parent holding company (SM 1329). These subsidiary adjustments are made to ensure that the non-jurisdictional operations of a parent holding company are supported with a capital structure appropriate for the risks of its operations, such that the capital structures of the subsidiary regulated entities are not subsidizing the costs of the non-regulated operations of the parent (SM 1329). The subsidiary adjustments are performed by subtracting a hypothetical capital structure, in an amount equivalent to the total capital structure of the non-jurisdictional operations, from the consolidated capital structure of the parent company (SM 1329-30).

Two subsidiary adjustments are needed before Iberdrola’s capital structure can be applied to its regulated subsidiaries, because it has two classes of non-jurisdictional assets that have significantly different risks. The first class is the pre-existing operations of Iberdrola that it has owned before it will consummate the acquisition. The second class of assets is goodwill.

a. The Pre-Existing Operations Adjustment

As to the first class of assets, in explaining that subsidiary adjustment in the recent NFG 2007 Rate Order, the Commission stated: "[I]t is not our intent to remove competitive operations at average competitive company capitalization ratios. We are removing competitive operations at ratios that would support the parent's rating at the level that it currently has."[28] Following this Commission precedent, Staff removed Iberdrola's pre-existing business operations from the pro forma post-acquisition capital structure using the parameters applicable to Iberdrola as an A-rated company with a business profile of 5 from S&P. Using Exhibit 102 as a guide, S&P indicates that the appropriate capital structure for a company with a business profile of 5 and a low A rating is composed of 50% equity and 50% debt. Therefore, in accordance with the Commission methodology in the NFG 2007 Rate Order Staff removed Iberdrola pre-existing operations of $55.4 billion from its pro forma capital structure at a rate of 50% equity ($27.7 billion) and 50% debt ($27.7 billion) (SM 1331).

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[28] Case 07-G-0141, National Fuel Gas Distribution Company, Order Establishing Rates For Gas Service (issued December 21, 2007)(NFG 2007 Order).

b. The Goodwill Adjustment

Staff’s second subsidiary adjustment is to remove $13.3 billion of goodwill from the pro forma post-acquisition capital structure of Iberdrola. Removing goodwill from the balance sheet is a logical extension of the Commission’s practice of not allowing goodwill to impact the rates of jurisdictional customers (SM 1332).

As discussed above, Staff views goodwill as a particularly risky asset for rate regulated entities. Given its ownership of regulated utilities, in order for Iberdrola to continue to recognize the value of the goodwill on its books, it must not only produce savings consistent to support its goodwill balance, it must also convince its regulators that the savings could not, and should not, have been generated other than as a result of the acquisition, and that it is reasonable to flow all or a portion of such benefits to shareholders for an extended time period. Given these uncertainties, it is sound financial policy for utilities to finance these large goodwill balances very conservatively -- with more equity and less debt.

Therefore, even though Iberdrola claims to have funded the acquisition entirely with equity, Staff imputed a capitalization of 75% equity and 25% debt to finance the goodwill on Iberdrola’s books. In the past, the Commission has removed unregulated operations from the consolidated capitalization by assuming that these entities were financed with between 60% to 70% equity. These ratios were deemed representative of the typical competitive company (SM 1334).

Again, as discussed above, goodwill carries more risk than that of the typical unregulated business operation (SM 1334). In general, more risky assets require a more conservative capital structure than less risky assets. Given that the Commission has used a ratio of 60% to 70% equity for a competitive business when making subsidiary capital structure adjustments, a higher equity ratio is needed to remove the risks of goodwill from Iberdrola’s consolidated capital structure. But rather than removing goodwill at 100% of capitalization, Staff chose to remove goodwill from Iberdrola’s consolidated capital structure by using an equity ratio of 75% and a debt ratio of 25%. This subsidiary adjustment removes approximately $10.0 billion from Iberdrola’s consolidated equity and approximately $3.3 billion from its consolidated long-term debt (SM 1334-35).

c. The Untenable Result

The ratemaking capital structure that results after these two adjustments, however, is untenable for ratemaking purposes. These adjustments therefore demonstrate that there is not enough equity to adequately support an A3 rating for all of Iberdrola’s current operating assets, its goodwill and the operating assets of Energy East (SM 1335-37). On the other hand Staff demonstrated that using the stand-alone capital structure for NYSEG and RG&E would produce an excess revenue stream from customers of $148 million annually, which would translate into $87 million annually of excess after tax profits to Iberdrola (SM 1341). Thus, rates set on a stand alone capitalization for NYSEG and RG&E would far overstate the actual financing costs of Iberdrola. Since neither a capital structure imported from Iberdrola nor a stand-alone structure is appropriate as a result of this transaction, the ratemaking capital structure for NYSEG and RG&E would necessarily be a hypothetical capitalization.

The fact that Iberdrola must squeeze excess profits from its inadequately financed capital structure argues for rejection of the transaction. If the transaction is approved, the company must be completely ring-fenced to the extent possible to ensure that customers receive the financial protections associated with the revenue stream they are paying. That revenue requirement would be based upon a capital structure consistent with an A rating. In this way, NYSEG and RG&E might obtain the strong A rating, above their current rating, implied by their respective equity ratios.

3. <u>The Petitioner's Arguments</u>

The Joint Petitioners attempt to rebut Staff's use of Iberdrola's consolidated capital structure, and subsidiary adjustments through the testimonies of Makholm, Fetter, and the Policy Panel. Their arguments are not persuasive.

a. <u>Witness Makholm's Arguments</u>

Witness Makholm characterizes the subsidiary adjustments as "re-engineering" (SM 1084). He claims Staff's use of a consolidated capital structure "does not appear to be required in this case and most certainly is not advisable" (SM 1085-86). He argues that, although the use of a consolidated capital structure "has some appeal because of the lack of alternatives" when the parent company is "almost a totally regulated entity," it is "neither necessary nor practical" in this case, because Iberdrola "heretofore has had nothing to do with regulated U.S. utilities" (SM 1084), and because both NYSEG and RG&E "will remain independently regulated operating companies in New York" (SM 1087).

The testimony of Witness Makholm displays a lack of understanding and regard for the Commission's policy regarding capital structure. That policy is intended to ensure that both the utility businesses of a holding company and its unregulated businesses are adequately financed. Witness Makholm's testimony fails to account for these policy concerns. Instead, by focusing solely on the utility operations of the holding company, he presents an incomplete assessment of how the company is financed. As explained above, Staff's use of Iberdrola's consolidated capital structure is both consistent with Commission precedent and appropriate because it is proper to assume that the parent corporation’s cost of capital is also the subsidiary’s, because it is the parent that raises capital, and because Iberdrola has not proposed any corporate restrictions or standards to separate Energy East’s capital structure from that of Iberdrola.

Witness Makholm’s attempts to distinguish Opinion No. 85-15 on the grounds that NFG was a holding company subject to broad regulation by the SEC and FERC (SM 1086). This argument should be rejected because NFG engaged in unregulated timber and gas exploration businesses, just as Iberdrola engages in unregulated businesses. That justifies the subsidiary adjustment in both cases.

The reasonableness of NYSEG’s and RG&E’s ratemaking capital structure, Witness Makholm asserts should be assessed by reference to various independent operating utilities regulated by commissions in other states, without looking to the Iberdrola parent, with its various mix of businesses (SM 1087). In effect, he suggests the Commission should ignore the reality of how two of its operational utilities are financed and instead look to other companies, and other States, for guidance. Again, this argument ignores the Commission’s established policy regarding capital structure.

Witness Makholm claims Staff's calculations on removing unregulated subsidiary operation effects from Iberdrola's capital structure and goodwill are subjective and reflect unsupported assumptions (SM 1087). He criticizes Staff's decision to back out $55.4 billion from Iberdrola's capital structure at a 50/50 capital structure ratio based on S&P figures for the U.S. This criticism is without merit. That ratio is consistent with the ratio for a weak A-rated international utility holding (Exh. 102, p. 3) -– which is Iberdrola's current profile. Therefore, that ratio is appropriately used to adjust Iberdrola's pro forma post acquisition consolidated capital structure.

Witness Makholm also criticizes Staff for backing out goodwill at a 75% equity/25% debt ratio, alleging that Staff's only justification is that such a ratio is "conservative" (SM 1088). Again, he misconstrues Staff's testimony. Staff characterized goodwill as an asset which is more risky than that of unregulated operations because goodwill produces <u>no</u> earnings for regulated operations and cannot service the capital supporting it (SM 1332-33). Staff also noted that previously the Commission has used equity ratios in the 60% - 70% range to remove the effect of unregulated operations from the consolidated entity's capital structure (SM 1334). Thus, to mitigate the risk of goodwill, Staff found that an equity ratio in excess of 70% is fully justified. Because equity is created solely through the booking of goodwill, removing goodwill from the parent's capital structure at a rate of 75% equity and 25% debt is conservative, compared to removing it with 100% equity.

Finally, Witness Makholm displayed his unfamiliarity with NYSEG and RG&E by saying that, even if this were a rate case in which the capital structures of NYSEG and RG&E were at issue (a proposition he opposes), there are other more reliable and objective methods for setting regulated capital structures (SM 1089). This ignores that, in the last NYSEG electric rate case, the question of the appropriate capital structure was fully and vigorously litigated, and the Commission decided in the NYSEG Electric Order,[29] to use the parent's capital structure for ratemaking purposes.

Witness Makholm also criticizes Staff's recommended ROE of 9.0% for NYSEG and RG&E, and asserts that, if the cost of equity were fully litigated, the evidence would show that a 9.0% ROE is unreasonably low (SM 1090). A review of recent Commission decisions, however, shows that Staff's recommended 9.0% ROE is reasonable. For example, in the 2008 Con Ed Rate Order, the Commission established an ROE of 9.1% for electric

[29] Case 05-E-1222, New York State Electric & Gas Corporation – Electric Rates, Order Adopting Recommended Decision With Modifications (issued August 23, 2006) and Order on Rehearing (issued December 15, 2006)(NYSEG Electric Order).

rates. In another recent case, the Commission adopted an ROE of 9.1% for Orange and Rockland Utilities, Inc.[30] Therefore, witness Makholm's claims that Staff's ROE of 9.0% is unreasonably low should be rejected.

b. Witness Fetter's Arguments

Witness Fetter, for his part, states that "goodwill is not debt and should not be treated as such" (SM 776). He claims "it is only when goodwill impairment poses a threat to a company's capital structure that rating agencies will focus upon potential negative credit profile effects, though they still do not treat impaired Goodwill as debt" (SM 776). Witness Fetter's conclusions, however, over-extend his point.

Goodwill is removed as equity from a company's capital structure under a variety of circumstances, not only in times of financial distress. For example, in cases such as this where an acquisition will not result in synergy savings, it is appropriate to remove Goodwill from Iberdrola's capital structure (Exhibit 86, page 5). Indeed, the fact that Goodwill is removed by credit agencies from a consolidated capital structure as 100% equity clearly shows that Staff's approach (i.e., removing Goodwill at a ratio of 75% equity/25% debt) is more conservative.

[30] Case 06-E-1433 et al., Orange and Rockland Utilities, Inc., Order Setting Permanent Rates (issued October 18, 2007), p. 15.

Witness Fetter also misses Staff’s main point. The issue is whether it is necessary to remove goodwill to determine whether Iberdrola’s capital structure can adequately support the operations of NYSEG and RG&E. Staff demonstrated that it is necessary to remove Goodwill in order to assess whether Iberdrola’s consolidated capital structure can support NYSEG and RG&E. Post transaction, Iberdrola would have goodwill and intangible assets equal to 46% of its equity balance. This would pose a significant hazard to ratepayers by creating a significant incentive at the holding company level to achieve savings in order to create returns on assets that support this large amount of goodwill (SM 1163). Over the long run, such a circumstance will not be sustainable, and such financial stress will lead to service quality problems (SM 1162). Given these risks, removing goodwill from the balance sheet is a logical extension of the Commission’s practice of not allowing Goodwill to impact the rates of jurisdictional customers (SM 1332).

Iberdrola's financial profile has been described as "aggressive" by S&P (SM 1156). Petitioners have acknowledged that the rating agencies have stated that Iberdrola’s use of aggressive amounts of debt could play a role in downgrading Energy East (SM 1065). The significant amount of debt financing in Iberdrola's capital structure is exacerbated by both the company's large amount of existing Goodwill and the incremental goodwill that will be created and assumed by the proposed transaction (SM 1156). Because of Iberdrola's aggressive financial profile, its pro forma post-acquisition capital structure will not adequately support NYSEG and RG&E's operations. This leaves the Commission with the choice of rejecting the transaction outright or approving the transaction with ring-fencing conditions that protect NYSEG and RG&E from the consequences of Iberdrola ownership, and allow Iberdrola to obtain a credit rating that is commensurate with its ratemaking capital structure.

c. The Policy Panel Arguments

Petitioners assert that the recent Iberdrola Renewables IPO, which raised $6.5 billion in equity to support Iberdrola's renewable capital expenditure program, fully addressed the leverage concerns of the ratings agencies. Petitioners also note that Iberdrola stated in its Strategic Plan 2008-2010 that up to 72% of its capital expenditure program will be financed by means of the Iberdrola Renewables IPO, operational cash flow, and divestments of over three billion euros (SM 555). The phrase of "up to 72%," however, is only a proposed ceiling and is not a guarantee as to how Iberdrola will carry out its Strategic Plan.

Nor is it a guarantee that Iberdrola will avoid over-leveraged in the future. And the $6.5 billion in equity produced from the Iberdrola Renewables IPO is unlikely to enhance Iberdrola's equity by that amount; the increase in its equity ratio will be limited to the after-tax gain on that transaction, which will be a considerably lower number. As a result, Iberdrola's ability to raise equity is not a factor that undermines Staff's analysis of capital structure risk.

III. VERTICAL MARKET POWER

A. The Commission's Policies

For well over a decade, the Commission has strongly supported the development of competitive wholesale markets for the supply of electric commodity (SM 900-02). From the inception of competitive wholesale markets, an integral component of the policies for their development has been the separation of ownership of T&D operations from the ownership of generation (SM 1247-48). As the Commission explicitly stated in Opinion No. 96-12, generation should be separated from T&D "in order to prevent the onset of vertical market power. Total divestiture of generation would accomplish this most effectively...."[31]

The policy of separating ownership of T&D from ownership of generation was continued in the Vertical Market

[31] Case 94-E-0952, Competitive Opportunities For Electric Service, Opinion No. 96-12 (issued May 20, 1996), p. 99.

Power (VMP) Statement.[32] As decided there, vertical market power occurs "when an entity that has market power in one stage of the production process leverages that power to gain advantage in a different stage of the production process."[33] A T&D company located in the same market as an affiliated generator, the Commission stressed, will have an incentive to obstruct entry of competing generators into that market, thereby raising prices in the region. Moreover, a T&D company will find it advantageous to preserve a transmission constraint that results in higher prices in the region where an affiliate generator is located.

The Commission found that these incentives to abuse market power must be minimized, because even vigilant regulatory oversight could not timely identify and remedy all abuses that a creative T&D company could pursue to achieve the benefits the incentives for VMP creates. As a result, the Commission announced it would be presumed VMP existed to the disadvantage of ratepayer interests under such circumstances. The Commission, however, did allow T&D utilities to rebut the presumption, if a utility could show that VMP could not be exercised under the particular set of ownership facts presented, or because VMP could be adequately mitigated, or because

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[32] Case 96-E-0900, et al., Electric Rate and Restructuring Plan, Statement of Policy Regarding Vertical Market Power (issued July 17, 1998).

[33] VMP Statement, App. 1, p. 1.

substantial ratepayer benefits attending a proposal, together with mitigation, overcame the presumption.

The VMP Statement was emphatically reaffirmed in the KeySpan/Grid Order. In particular, the Commission noted that divestiture to accomplish the separation of generation and T&D ownership was the preferable approach, "because vigilant regulatory oversight cannot timely identify and remedy all abuses."[34] Eliminating the incentives VMP would create was considered superior to reliance upon behavioral remedies, such as supervision of T&D utility operations by the New York Independent System Operator (NYISO) and the Federal Energy Regulatory Commission (FERC).

Notwithstanding the nearly decade-long experience with NYISO and FERC since issuance of the VMP Statement, the Commission in the KeySpan/Grid Order accepted arguments that FERC failed to focus on removing the incentives for exercising VMP. As a result, the Commission remained concerned that subtle actions or failures to act, "such as a failure to perform required maintenance or a failure to propose and build needed transmission would remain difficult or impossible to detect."[35]

As the Commission stated, reliance on FERC or the NYISO to mitigate VMP was not a solution, because that reliance

[34] KeySpan/Grid Order, p. 129.

[35] KeySpan/Grid Order, p. 134.

would not limit or eliminate opportunities to exercise VMP "that would be hard or impossible to detect." The Commission concluded that it would not weaken its "resolve to ensure a competitive generation market and its intended benefits."[36] It made this determination even though the T&D utility and the generator with which it would affiliate were not present in the same market much of the time.

B. The Transaction and the Creation of VMP

Iberdrola's proposed acquisition of Energy East is in blatant conflict with the VMP Statement and the KeySpan/Grid Order. Iberdrola's effort to combine substantial amounts of wind generation with the NYSEG and RG&E T&D systems would also undo the successful divestiture of RG&E's Ginna nuclear plant, and retreat from the slow progress made towards full divestiture at that utility.

The T&D operations of NYSEG and RG&E extend over a broad swath of territory in upstate New York. They own 2,433 miles of transmission, including two major transmission lines connecting the upstate market to the neighboring PJM market (SM 1252). In addition, approximately 300 MW of generation takes natural gas transportation service from NYSEG and RG&E, and an additional 314 MW of such generation is planned for those

[36] KeySpan/Grid Order, p. 134.

service territories, as evidenced by requests for interconnection through the NYISO queue.

Moreover, NYSEG, RG&E, and a lightly-regulated Energy East affiliate, Carthage Energy, LLC (Carthage), continue to own 546 MW of existing generation. To that generation, Iberdrola would add 176 MW of wind generation it already owns and planned wind generation that results in a total of nearly 1,300 MW (SM 1256, Exh. 57). The potential for the exercise of VMP under these circumstances is high, and the harm to ratepayers could be extensive.

1. Interconnection of Competitors

Generators planning to compete with Energy East or Iberdrola need the NYSEG and RG&E T&D systems to bring their energy to market. In addition, if they are to realize installed capacity (ICAP) revenues, they must incur an additional cost of entry by funding upgrades to the transmission system of NYSEG and RG&E (SM 1255). Notwithstanding NYISO and FERC supervision, NYSEG and RG&E possess the means to hinder competitors attempting to participate in the same markets as generation projects owned or controlled by Iberdrola.

NYSEG and RG&E could make it more difficult for competitors to interconnect in their service territories. Although the NYISO does police interconnections, and has extensive regulations and procedures for insuring that interconnections are made promptly and fairly, NYSEG and RG&E still owns the systems where the interconnections are made (SM 1274). As the Commission noted in the VMP Statement and the KeySpan/Grid Order, subtle action might be taken to delay interconnections of competitors that would be difficult for the NYISO to detect.

2. Discriminatory Practices

Even more serious is the threat of discriminatory action in the operation of the T&D system after interconnection. For example, Ginna Nuclear Power Plant, LLC (Ginna), an independently-owned generator located in RG&E's service territory, has complained that it has been required to substantially reduce its output because of actions RG&E took to maintain its transmission system (SM 1265-66). Whatever the merits of Ginna's particular complaint, it is clear that a T&D owner that is unaffiliated with generating facilities would have no perverse incentive to require a generator to reduce output unnecessarily when performing maintenance on the T&D system.

In contrast, since RG&E is affiliated with competing generators, its parent would benefit from RG&E's actions that reduce competitors' output. To the extent a competing generator like Ginna cannot bring its power to market, market prices rise in the entire upstate region, since NYISO Zones A through E generally operate as a single market. Consequently, the parent’s Carthage affiliate would be paid more for its generation when Ginna is unable to deliver its generation to market, while Ginna, of course, is paid less.

These maintenance practices can have significant adverse effects on market prices. Preventing Ginna from delivering its generation to market increased some NYISO prices to levels 55% higher than they were when Ginna was able to deliver (SM 1272-73).

These types of discrimination in maintenance practices are very difficult to detect and prevent. The position of the Rural Co-ops in this proceeding evidences this difficulty. They maintained that, through the simple expedient of relocating line crews and reducing line crew staffing, NYSEG has substantially reduced the reliability of the system used to deliver electricity to them. This sort of subtle management practice, similar to the Ginna circumstances, engenders detailed factual disputes that can drag on for long periods of time, even though the competitor is losing money.

Affiliating with Iberdrola’s wind interests substantially exacerbates the extent of these incentives that are adverse to ratepayer interests. As the petitioners concede, Iberdrola’s wind affiliates generally are price takers, because they are paid at the NYISO market price prevailing at the time they operate. It would be a relatively simple matter for RG&E

and NYSEG to arrange for maintenance that would adversely affect Iberdrola's wind competitors' ability to deliver power during times when that action would raise the prices Iberdrola earns. This is exactly the kind of perverse incentive that the VMP Statement and the KeySpand/Grid Order are intended to prevent, because ratepayers would pay more for wind generation as a result overall.

Even worse, wind competitors of Iberdrola could be discouraged from building facilities in the NYSEG and RG&E service territories. If they come to believe that the Commission is not serious about preventing the exercise of VMP, they might hesitate to make investments in the NYSEG and RG&E service territories (SM 1276), especially since Iberdrola now admits it plans to build wind facilities in those service territories (Exh. 57). Seeing the difficulty that Ginna is already experiencing in delivering its electricity, there is a very real risk that they might decline to make the substantial investments necessary to compete with Iberdrola out of a legitimate concern that anti-competitive practices will be exercised against them.

3. Other Avenues to the Exercise of VMP

The existence of VMP opens two other avenues for raising prices adverse to the interest of ratepayers. Since NYSEG and RG&E lie athwart connections to PJM and Canadian markets, they could decline opportunities to reduce transition constraints from those markets (SM 1250). That would maintain unnecessarily high prices for all participants in the upstate New York market, including their affiliated generators.

As to the second avenue, NYSEG and RG&E could make it more difficult to interconnect new gas generating facilities with their gas transportation system. The NYISO exercises no control over gas interconnection practices, so the utilities could attempt to engage in more blatent anti-competitive activity than is feasible for electric interconnections (SM 1276-77). Of course, competitors could file complaints, but, again, complaints take a substantial amount of time to resolve, and all the while the competitor is losing money, the affiliated generators are earning excess profits, and consumers are paying higher prices for generation supply.

C. Energy East’s Generation

Energy East’s existing generation could also benefit from the exercise of vertical market power by NYSEG and RG&E. Those two utilities own both hydroelectric and gas-fired generation.

1. The Carthage Affiliate

Energy East’s Carthage affiliate sells its energy at market-based rates (SM 1264). To the extent market prices rise in upstate New York, the Carthage facility is paid more. An incentive therefore exists for NYSEG and RG&E generally to raise prices in Upstate New York, through vertical market power.

Indeed, some incentive for even horizontal market power exists, because if prices can be raised for the Carthage facility through withholding the gas and hydro facilities from the market, there is an opportunity for the overall holding company entity to earn more. This is so especially because the cost of operating the utility facilities are recovered from ratepayers whatever the market price.

2. The Russell Site

Another VMP issue is the fate of RG&E's existing Russell Station. Because that obsolete generation facility must cease generating to comply with environmental requirements, RG&E promised to shut down the station and to sell the site, once transmission upgrades were accomplished to ensure reliability into the Rochester area where the station is located. Indeed, in the Joint Proposal underlying the CENPC Order, RG&E stated that it would "fulfill its commitment (made on the record in RTP-0051) to file an appropriate competitive auction process with a goal of the sale of the Russell Station site to a non-affiliated entity."[37] This would fulfill the Commission's

[37] Case 03-T-1385, Application of Rochester Gas and Electric Corporation, Order Granting Certificate of Environmental Compatibility and Public Need (issued December 16, 2004), App., p. 57.

divestiture policies, which apply to RG&E, but have been implemented only slowly there because of factors unique to that utility (SM 906-11). It now appears, however, that RG&E plans to renege on its Russell commitment by repowering the facility (SM 912-15, 1263).

RG&E has attempted to pursue redevelopment of the Russell site under its own ownership through the NYISO's Reliability Needs Assessment (RNA) process. To oversimplify somewhat, that process provides for alternatives to the construction of generation in wholesale competitive markets, where a project is needed to preserve electric system reliability. The NYISO, however, rejected RG&E's claim that it was entitled to certain RNA findings essential to pursuing the utility's proposed Russell redevelopment project for reliability needs (SM 912-14, 1862-64).

If, however, RG&E continues to pursue the project, another incentive for the exercise of VMP is created. RG&E could attempt to justify the prudence of the project based on a forecast of market prices, by showing that it could build a generation facility that would produce generation at less than those market prices. This risk is of special concern, because RG&E's own estimates show the proposed repowering is uneconomic (SM 914).

The exercise of VMP, however, could assist RG&E in shielding it from the effects of a prudence review. It could, through the exercise of VMP, attempt to increase the price of generation to levels that exceed its forecast. Then, if the costs of building its facility also exceed forecast, it could compare the price of generation to the actual higher market prices. It would claim that, even though it might have been imprudent in the construction of the facility, there was no harm to ratepayers because the price of the facility's generation was below market prices –- even though those prices would have been artificially enhanced through VMP.

The proposal to repower Russell poses the potential to burden ratepayers with uneconomic costs. Added to those costs are those that could arise from the continued exercise of VMP. Given Energy East's demonstrated lack of concern for ratepayers, and its disregard for the Commission's VMP policies, the remedy is divestiture of all its generation.

D. The Rebuttable Presumption

Finally, the VMP Statement does allow utilities to seek to rebut the VMP presumption under certain circumstances. The VMP Statement noted that a relatively small T&D utility located in a broad market might possess but little ability to discourage new entry. The breadth and extent of NYSEG and RG&E T&D operations and their ownership of nearly 600 MW of generation, coupled with Iberdrola's plans to own or build nearly 1,300 MW of wind generation, take their proposal well outside the parameters of what is an acceptable rebuttal to the presumption. The petitioners' efforts to rebut the presumption otherwise, discussed further below, are not convincing.

Therefore, the transaction Iberdrola and Energy East propose conflicts with the requirements of the VMP Statement. It should be rejected on those grounds alone.

E. The Petitioners' Arguments

The petitioners' response to the VMP issue is, essentially, to deny that vertical market power exists. They dismiss the VMP Statement and the KeySpan/Grid Order, with their Witness Hieronymus describing the VMP analysis in the latter as "utter nonsense" (SM 891). In support of that reasoning, they offer a series of unpersuasive and irrelevant arguments that the rebuttable presumption in the VMP Statement has been satisfied.

Until presentation of the Partial Acceptance, petitioners declined to propose any mitigation measures to bolster their unconvincing rebuttable presumption presentation. As discussed below, the mitigation suggested in the Partial Acceptance -- the sale of Energy East's gas-fired generation -- is only a first step towards meeting the rebuttable presumption, and is inadequate to support a finding that the petitioners have satisfied VMP concerns.

1. The VMP Statement and FERC Oversight

The petitioners, in effect, ask that the Commission retreat from the VMP Statement and the KeySpan/Grid Order. They begin their attack on those Orders by dismissing the VMP Statement as outdated and outmoded. They claim that NYISO and FERC over-sight of the transmission ends VMP concerns.

As discussed above, however, the KeySpan/Grid Order rejects that argument, because NYISO and FERC oversight cannot prevent subtle exercises of VMP. The reasons for so concluding are detailed in Exhibit 98, where three means of exercising vertical market power notwithstanding FERC supervision are described. First, utility maintenance practices can be manipulated to slow the repair of transmission lines for the purpose of benefiting an affiliated generator. Second, a T&D utility can decline to make transmission investments that will reduce market prices, if its affiliated generator will benefit. Third, a T&D utility may act slowly to correct voltage support shortcomings, thereby effectively reducing transfer capability on the bulk power system. Given that Exhibit 98 was prepared in 2006, and the even more recent KeySpan/Grid Order, the petitioners' claim that NYISO and FERC oversight eliminate or mitigate VMP concerns in New York lack support (SM 917-18).

The petitioners also point out that FERC has approved Iberdrola's acquisition of Energy East, finding that VMP concerns are not present. When addressing this issue in approving the KeySpan/Grid merger, however, FERC found that this Commission "is the appropriate body to determine whether the merger is consistent with the [VMP Statement]."[38] FERC therefore concedes that its VMP findings are not binding on this Commission. In fact, FERC concedes that it did not address the VMP issues that concern this Commission.[39] Just as this Commission made its own determinations on VMP following FERC approval of the KeySpan/Grid merger, it should make its own VMP findings regarding this transaction.

2. Wind Generation Capacity

Other arguments the petitioners make are similarly unconvincing. The petitioners make much of the fact that the amount of capacity associated with Iberdrola's wind projects is limited (SM 816). Whatever the accuracy of the petitioners' wind capacity calculations, that analysis would be primarily directed to horizontal market power concerns. Here, the concern with the wind generator is primarily vertical market power -- that the T&D companies will respond to an incentive to raise market prices to the benefit of the wind generation. The size and scope of Iberdrola's planned generation -- at nearly 2,000

[38] Docket No. EC06-125-000, National Grid plc, 117 FERC ¶61,080 (2006), ¶61,419.

[39] Docket No. EC07-122-000, Energy East Corporation, 121 FERC ¶61,236 (2007).

MW -- would benefit even from minute increases in price. During a windy day when nearly all of that generation is in operation, even a small additive to the per kWh price will result in millions of dollars of overpayments by New York ratepayers.

The connection to such overpayments is even stronger under these circumstances than in the KeySpan/Grid circumstances, notwithstanding witness Hieronymus' unsupported contention to the contrary (SM 856). Here, the T&D systems and the affiliated generation are all located in the same market region, while in KeySpan/Grid, the relationship was more attenuated, with National Grid's transmission system located upstate and the KeySpan/Ravenswood generation facility located in New York City. If the connection between T&D and generation there was strong enough to raise a VMP concern, the connection here is more than sufficient.

3. The Effect of Long-Term Contracts

Witness Hieronymus also maintains that the Commission's support for the VMP Statement and the KeySpan/Grid Order were weakened with the issuance of the ERP Order.[40] There, the Commission decided that utilities could enter into long-term contracts for the purchase of generation under certain

[40] Case 07-E-1507, Long-Range Electric Resource Plans (issued December 24, 2007).

circumstances. Witness Hieronymus equates long-term contracts with ownership of generation (SM 851-53).

Nothing in the ERP Order, however, is even relevant to the VMP Statement. The Commission addressed in that Order only the use of contracts to obtain new generation, when not provided by the market and needed to satisfy long-term reliability or energy policy goals and needs. Indeed, the Commission recently issued its Order on Rehearing in the matter specifically finding that it did not adopt "any new policies regarding: vertical market power; the risks of utility construction, ownership and operation of generation; or the possible use of utility contracts for reliability or policy purposes."[41]

Nor is witness Hieronymus' point on long-term contracts convincing. That such contracts may, under some circumstances, be reflected when conducting a horizontal market power analysis does not reflect a role they play in a vertical market power analysis. As witness Hieronymus admits, when a utility purchases from a generator under a contract at a fixed price, that utility sees no incentive to raise market prices (SM 875). In contrast, when a T&D utility is affiliated with a generator, and the parent will benefit from higher market prices paid to that generator, there is such an incentive.

[41] Case 07-E-1507, supra, Order Denying Petitions For Reconsideration or Clarification (issued March 21, 2008), p. 3.

Furthermore, as witness Hieronymus implicitly admits, contracts can play a role in eliminating VMP concerns. As he points out, the KeySpan/Grid Order did not express concerns related to KeySpan's ownership of generation whose output is sold at fixed long-term contract prices to the Long Island Power Authority (LIPA). Therefore, exempting the KeySpan/LIPA plants from VMP analysis was proper, and did not, as witness Hieronymus implies, constitute an exception from the VMP policies of the Commission.

4. <u>Iberdrola's Wind Affiliate Interests</u>

The petitioners also claim that the exercise of VMP will not adversely affect the development of wind generation in New York. They point to the healthy number of wind generation projects listed in the NYISO's interconnection queue for upstate New York (SM 862). They maintain that no developers have yet left the queue because Iberdrola is proposing to enter the State, and that, even if some did leave, participants in the queue already outstrip the ability of the transmission system to absorb all of their projects. As a result, the loss of a few projects would not adversely affect the State's ability to achieve its renewable development goals.

The petitioners' argument is misplaced. The queue will not empty of Iberdrola's competitors until Iberdrola actually begins to exercise VMP. Because it does not yet own the NYSEG and RG&E T&D utilities, there is at present no incentive to benefit affiliated wind projects.

Once VMP is exercised, however, it will be too late to correct its ill effects on renewables development. Competitors of Iberdrola that fear its exercise of market power will quickly leave the State for markets that operate fairly. As Iberdrola itself has stated, many opportunities to develop wind projects exist outside of New York and developers seeking to pursue the best opportunities could easily disregard New York. As a result, the harms of VMP will not be felt until too late to rectify them.

Witness Hieronymus also fails to include in his analysis of the size of Iberdrola's wind operation additional wind facilities that Iberdrola may control. It is difficult to determine the extent of Iberdrola's far-flung operations. For example, Iberdrola denies that it controls projects in the western New York interconnection queue owned by Gamesa, USA (Gamesa). Iberdrola virtuously maintains it has nothing more than publicly-available information on the operations of Gamesa (SM 599-602).

The facts indicate otherwise. Iberdrola owns 25% of Gamesa, surely an interest large enough to influence its operations. Indeed, Iberdrola concedes that the sale of 20% of its interests in Iberdrola Renewables means that it must consider the opinions of other owners (SM 670-72). Surely, Gamesa will respond to Iberdrola as Iberdrola expects to respond to its co-owners.

Moreover, Iberdrola admits that it was able to purchase from Gamesa wind projects that Gamesa was developing in states other than New York (Exh. 56). While Iberdrola entered into contracts with Gamesa facilitating the flow of information from Gamesa relevant to the evaluation of those projects, most likely its initial interest in those projects arose out of its ownership of Gamesa. Moreover, nothing prevents it from entering into similar contracts for the outright purchase of the New York Gamesa projects.

Finally, Iberdrola owns some of its interests in Gamesa indirectly, in cooperation with another partner. It admits that it carefully evaluated its investment in Gamesa with that other partner (SM 599-607), based on information that most likely went beyond that available to the general public, notwithstanding its protestations to the contrary. And, as the Wall Street Journal reports, Iberdrola's relationship with Gamesa is strong enough for Iberdrola to "lock up" Gamesa's order book for the wind turbines Gamesa affiliates manufacture (Exh. 92). As a result, Iberdrola's claim that it had little or no effect on Gamesa's operations is unconvincing.

Similar circumstances exist in Iberdrola’s ownership of the Maple Ridge Wind Farm, also known as Flat Rock. It claims it has only a 50% interest in that project. But it also owns a 9.5% interest in its co-owner, a Portuguese utility. While Iberdrola denies that it can exercise any control over its co-owner, again, its substantial interest in that co-owner indicates otherwise.

The ability of Iberdrola to expand upon its control of wind generation projects in New York is troubling. While horizontal market power concerns raised in this proceeding have been less important than vertical market power concerns, even Witness Hieronymus admits that at some point Iberdrola could control enough generation to raise those concerns. If, through a web of affiliates, Iberdrola comes to control an undue number of the limited prime wind project sites in New York, more concerns would be raised about this transaction. That Iberdrola seeks to minimize the connection it has with affiliates like Gamesa is disturbing, in evaluating its overall intentions.

F. Conclusion

The potential for the exercise of VMP the transaction raises is in direct conflict with the Commission’s VMP policies, which were reaffirmed less than a year ago in the KeySpan/Grid Order. Moreover, this is the time to complete the long process of moving NYSEG and RG&E into full compliance with the VMP policies, and to address the risks to ratepayers that RG&E's proposed repowering of Russell poses. Accordingly, the petitioners' efforts to avoid the implementation of the Commission's VMP policies should be rejected.

IV. CONDITIONS NECESSARY FOR APPROVAL

While Staff recommends that the Commission reject the transaction, in the event that the Commission decides it should be approved, Staff proposes conditions for that approval. These conditions are modeled on those adopted in the KeySpan/Grid Order, and so are appropriate for use here.

The proposed conditions that should be attached to approval fall into three categories. First, tangible monetary benefits that outweigh the risks associated with the transaction should be required. Because petitioners contend that this transaction does not create any synergy savings, tangible benefits must be found elsewhere. Staff proposes positive benefit adjustments (PBA) that can be substituted for synergy savings as the source of the necessary tangible monetary benefits.

Iberdrola's acquisition of Energy East raises the potential for the exercise of VMP, which is best remedied through divestiture, as the Commission decided in the VMP Statement and the KeySpan/Grid Order. Staff therefore recommends that Energy East and Iberdrola be required to divest, all of their generation assets as a condition for consummating the acquisition of the NYSEG and RG&E T&D companies.

The affiliation of NYSEG and RG&E with a holding company of Iberdrola’s size and scope creates substantial risk. The same types of risks were addressed in the KeySpan/Grid Order. There, the Commission required financial and structural protections to protect New York regulated utility ratepayers from the risks affiliation with the holding company. Staff proposes that the financial and structural protections adopted in the KeySpan/Grid Order also be adopted here.

A. Staff’s Tangible Benefits

Staff has devised the tangible benefits that should be required in this proceeding, as a condition of approval of the transaction. Because petitioners deny that they can achieve synergy savings -- a proposition Staff rejects –- a source for tangible benefits other than synergies must be found. That source, however, exists. NYSEG and RG&E can adjust regulatory assets and reserves, by writing down some credits owed them and writing up some credits they owe ratepayers, to create the Positive Benefit Adjustments (PBAs) that could justify approval of this transaction (SM 1366-68). And these PBAs also will compensate ratepayers for any synergy savings, currently hidden from view, that Iberdrola might retain in the future.

1. Synergy Savings

The petitioners claim that there are no synergy savings here (SM 526). But they admit that they conducted no studies in an attempt to uncover any synergy savings. Moreover, they also admit that they were able to extract more than double the synergy savings originally estimated from Scottish Power, after their acquisition of that company (SM 644-45). As a result, the claim that there are no synergies here is suspect.

Although the petitioners deny that the transaction will create synergy savings, their denial is not absolute. Witness Meehan admits that economies of scale, economies of witness scope, and shared learning could create benefits (SM 955-56). Therefore, Staff believes that it is possible that some synergies will be achieved.

For example, petitioners claim that Iberdrola's expertise will enable NYSEG and RG&E to upgrade their best practices, synergy savings might be found if those upgrades are successful (SM 941-43). More synergies may be achievable in the area of information technology (IT)(SM 1208).

While petitioners argue that combining NYSEG's and RG&E's existing IT systems with other systems Iberdrola owns will not create savings, they admit that their IT systems are very complex, a conclusion that confidential information submitted in this proceeding supports. And they admit they achieved far greater synergy savings after the acquisition of Scottish Power than they originally estimated (Exh. 19, Response IBER-1667). As a result, synergy savings from IT and "best practices" remain a possibility here once complexities are fully analyzed, even if the savings cannot be quantified at present.

Besides the transmittal of best practices, and IT savings, there may be other areas where synergy savings can be realized as a result of this transaction (SM 1206-08). Quantification of any of the synergies, however, remains elusive, obstructed by the petitioners' refusal to concede that synergy benefits will be realized in this transaction, and refusal to quantify the "economies" they admit do exist. But before it entered into the transaction Agreement with Energy East, Iberdrola determined that [redacted] By denying the existence and extent of synergy savings, however, the petitioners can retain for themselves any such savings that are realized (SM 1207-08).

Therefore, it should be concluded that synergy savings exist, but are hidden and are not readily quantifiable. As a result, PBAs are necessary to substitute for the missing synergy savings. The PBAs must be large enough to offset the potential that synergy savings will be realized, but that, because they have not been quantified here, Iberdrola will retain all of the synergy benefits. As a result, tangible benefits in this proceeding must be found elsewhere than in synergy savings, but it must be remembered that those tangible benefits must be significant enough to offset the possibility that Iberdrola will retain some synergy savings.

2. The Justification For the PBAs

To create the tangible monetary benefits necessary for approval of this transaction, Staff proposes the PBAs, which for the most part, are quantifications of adjustments to "paper" assets. These sorts of book adjustments are a common occurrence when a company is acquired.

The PBAs Staff recommends amount to $644 million (pre-tax or $387 million after tax)(SM 1368). Since the adjustments are made to non-cash assets, there would be no impact on current cash flows at NYSEG and RG&E. This avoids long-term impairments to the utility's finances.[42]

Staff's PBAs are a reasonable sum to require as a condition of approval. The amounts create the benefits

[42] A one-time adjustment of $49.2 million, to the costs NYSEG must pay under a contract with an independent power producer, would be a cash charge, but is not significant enough to cause cash flow problems.

necessary to warrant approval of the transaction, and to offset the risks attending the transaction.

To evaluate the reasonableness of its proposed PBAs, Staff made three comparisons. First, in many recent merger approvals, including the formation of Energy East and KeySpan/Grid, merger savings were shared at least equally, 50% to ratepayers and 50% to shareholders. In this case, Staff calculates the benefits of the transaction at an amount of at least $1.6 billion. Fifty percent of that amount would yield a benefit of $800 million, so Staff proposes benefits here that are proportionately less than in KeySpan/Grid.

Moreover, since this is a PSL §70 proceeding, comparison to other §70 evaluations is of some value. The gain on an asset sale is generally directed primarily to ratepayers. For example, 95% of RG&E’s gain on the recent sale of its Ginna nuclear facility was directed to ratepayers. Since Iberdrola is, in effect, acquiring all of the assets of Energy East, the principle that ratepayers are entitled to share in the gain is well-established (SM 1369).

Finally, Staff analyzed recent merger and acquisition approvals to determine the levels of ratepayer benefits imputed in rates. When Energy East was formed, the benefits captured for customers represented about 6% of the involved utilities’ delivery revenues. In the recent KeySpan/Grid merger, the benefits captured amounted to about 10% of the utilities' delivery revenues. The PBAs Staff proposes here amount to about 11% of the NYSEG and RG&E delivery revenues on an equivalent basis (SM 1370, Exh. 107). Staff's proposed PBAs are a reasonable substitute for the synergy savings that have been required in other energy utility mergers. They should be required here.

3. Comparison to the Overall Benefits of the Transaction

In opposing Staff's PBAs, the petitioners first attempt to mischaracterize them by confusing the distinction between the PBAs themselves and the tests used to justify them.

The PBAs are asset write-offs and ratepayer credit write-ups that can be readily accomplished on the books of NYSEG and RG&E. They are not, as the petitioners attempt to portray them, efforts to divert monies away from any other participant in the transaction. Requiring the PBAs as a condition of approval of the transaction is not, contrary to the petitioners' claim, an effort to obtain for ratepayers a portion of the shareholder acquisition premium, Spanish tax benefits, federal production tax credits (PTC), or transaction fees paid Energy East employees, lawyers or consultants.

Referencing the benefits other parties receive (Exh. 106), however, is a reasonable means of establishing the benefits that should be directed to ratepayers. It should be emphasized that, while Iberdrola believes it appropriate to expend more than $4.5 billion in payments to entities and individuals participating in this transaction, the amount it would direct to ratepayers in comparison to that sum is zero. Such a position is untenable.

a. The Shareholder Gain

In particular, Staff is not attempting to divert from shareholders the $930 million in gain they will receive as a premium for the sale of their stock (SM 1219). Referencing that benefit for comparison purposes is not the same as insisting that a portion of the shareholder gain be diverted to ratepayers.

As the Commission decided in the Con Ed-O&R Merger Order (p. 16), the premium paid shareholders at an arms-length transaction belongs to them. It should be noted, however, that in that merger, the overall benefits, of $468 million, exceeded the premium paid to shareholders, and 75% of the $468 million was directed to ratepayers. As a result, the Con Ed-O&R Merger Order actually supports Staff's contention that ratepayers should receive $644 million in benefits in some form as a result of the Iberdrola - Energy East transaction.

The petitioners also seek to reduce the magnitude of the $930 million premium. They claim that shareholders who receive a premium must pay taxes on their earnings. That fact does not countermand the fact that the proper measurement of economic gain to shareholders is the difference between the market value of the shares and the acquisition price, because that is the value the shareholders agree to accept.

Moreover, inquiries into the taxing of the premium in the hands of its recipients are problematic for a number of reasons (SM 1526-28). Substantial portions of Energy East's stock are likely held in non-taxable accounts, such as pension plans or §401(k) trusts, and capital gains taxes on the premium are currently set at relatively low percentages. And while the cost basis of each individual shareholder will serve as the starting point for calculating the tax they must pay, arriving at that figure for the many shares outstanding is not feasible or particularly relevant.

b. The Spanish Tax Benefit

There is ample reason to find that Iberdrola will receive a substantial tax benefit in Spain as a result of this transaction. Under Spanish law, apparently intended to encourage Spanish corporations to expand, Iberdrola may obtain a tax deduction for goodwill created on its books as a result of an acquisition transaction. Iberdrola complains that its receipt of the tax deduction is uncertain, but, tellingly, it continues to pursue the deduction available to it from the Scottish Power transaction. If successful there, it will certainly pursue the deduction here. The tax benefit is therefore a reasonable source of making a comparison.

c. <u>The PTC Benefit</u>

Staff calculated that Iberdrola will receive approximately $150 million in PTCs in 2008 (Exh. 100). The petitioners strenuously dispute the making of a comparison to the PTCs. It is the petitioners, however, that told Staff and the public when this transaction was first announced that use of the PTCs was a major consideration in consummating the transaction, because Iberdrola could offset PTCs against NYSEG and RG&E taxable income (SM 1553). That the petitioners have now retreated from that position does not vitiate the comparison.

The petitioners claim that existing PTCs have already been accounted for in the equity investment structures used to develop their existing wind projects. Staff's $150 million figure, however, is a forecast of 2008 tax benefits, and is not an effort to arrive at any existing PTCs which may have been allocated to equity investors.

When addressing future PTCs, petitioners concede that they may be directed to the offset of a variety of earnings and that they will make this decision on the use of those PTCs "taking into consideration its tax liability and the tax liability of those entities with which it is consolidated for tax purposes” (SM 531). Those entities, of course, could include NYSEG and RG&E. Therefore, Staff’s comparison remains valid.

d. Transaction Costs

The petitioners also dispute the relevance of the $46 million Iberdrola will expend in transaction costs (Exh. 107). Most of those costs are incurred as payments made to investment bankers and advisors. Many of them will be paid a flat fee for their services, regardless of the level of time and effort put forward. Clearly, the parties receiving these fees benefit from them, and all such benefits are a proper source of comparison to the benefits that ratepayers should receive.

4. Comparison to Asset Sales

The petitioners also object to Staff’s comparison of the Iberdrola acquisition transaction to an asset sale made by a regulated utility. The comparison is sustainable, to the extent that both transactions fall within the ambit of §70 and both require that benefits be directed to ratepayers in order to justify approval. Even though, as the Con Ed/O&R Merger Order points out, sales of individual assets funded by ratepayer dollars present benefit allocation principles different than the allocation of benefits in an acquisition transaction such as Iberdrola proposes, the point remains that some level of benefits must be provided.

5. Comparison to Other Utility Mergers

The petitioners maintain that Staff's calculations are flawed. They criticize both the comparison to the KeySpan/Grid transaction and complain that Staff has not properly reflected the impacts of its adjustments on the utilities' earnings. Both of these lines of criticism lack merit.

a. Comparison to KeySpan/Grid

Staff has accurately compared the effect of the $644 million in PBAs it would achieve for ratepayers through this transaction to the $602.8 million at issue in the KeySpan/Grid merger. The petitioners argue that the $602.8 million figure is not a proper analysis, and that the true benefits of the KeySpan/Grid merger amount to only $317.6 million (Exh. 79). They then divide that figure by $23.7 billion, which is the sum of the delivery revenues of LIPA, Niagara Mohawk, KEDLI and KEDNY. The petitioners then claim that the true benefits of the KeySpan/Grid merger were only 1.34% of delivery revenues, which equates to a PBA figure here of $87 million. This calculation is contrived.

It is not proper to reduce the $602.8 million figure by $285 million. $90 million of that reduction is attributed to synergy savings realized in the KeySpan/Grid merger. Of that number, $45 million is attributable to the ratepayers' share of synergies. PBAs, however, are a substitute for synergy savings, and so synergy savings must remain in the comparison.

The deduction of the remaining $45 million out of that $90 million, allegedly for the shareholder share of synergies, is disingenuous (SM 991). The $602.8 million starting point for calculating ratepayer savings in KeySpan/Grid is calculated after the shareholders have already received their portion of the synergy savings. This $45 million deduction is therefore simply a double-count of a number that was never included in the initial figure to begin with.

The petitioners also removed $195 million for benefits that they say would have occurred even in the absence of the KeySpan/Grid merger. However, that figure was propounded by the proponents of the KeySpan/Grid merger, and so remains a number upon which the Commission relied in its approval.

The petitioners also included the delivery revenues of LIPA and Niagara Mohawk in their calculation. The $602.8 million of benefits, however, went exclusively to KeySpan subsidiaries KEDNY and KEDLI. Since the KEDNY and KEDLI delivery revenues amount to only $5.8 billion, while $18.1 billion are attributable to LIPA and Niagara Mohawk, adding the latter revenues seriously distorts the calculation. As a result, only KEDNY and KEDLI delivery revenues should be recognized in the calculation. Staff’s calculation, at Exhibit

106, is therefore proper, and the petitioners' calculation, at Exhibit 79, should be rejected.

The petitioners misinterpret the KeySpan/Grid Order in other ways. Although it is clear that the Commission was disappointed that the $602.8 million figure included benefits that could have been realized absent the merger, the fact remains that the Commission relied upon that number in approving the merger (SM 985-87). The petitioners admit that the overall number was the mitigation that the signatories themselves claimed, and the Commission so characterized it (Exh. 79; KeySpan/Grid Order, pp. 116-17).

Moreover, even with the otherwise-achievable benefits eliminated, the benefits the Commission calculated for KEDNY and KEDLI remained at $400 million. The Commission also viewed another $496 million in benefits to Niagara Mohawk and LIPA ratepayers as a benefit of the transaction, unrelated to the directly-affected KeySpan delivery subsidiaries. Therefore, given all these factors, Staff's $600 million in PBAs is a reasonable approach to determining the tangible financial benefits that should be required here.

b. Comparison to CMP

Another reason to require the PBAs is that the petitioners agreed to furnish tangible monetary benefits in Maine, where another of Energy East's electric and gas delivery affiliates -- Central Maine Power (CMP) –- is located. In approving the transaction in Maine, the Maine Public Utilities Commission (MPUC) found additional ratepayer value in two areas -- Energy East's agreement to forego recovery of an acquisition premium in regulated delivery rates and the agreement to levelize the revenue requirement associated with a proposed Advanced Metering Infrastructure initiative (AMI), through foregoing carrying charges on the deferred costs accrued in making the AMI investment.

Forgoing the acquisition adjustment could amount to a total of $306 million, albeit CMP was seeking to recover only approximately $9 million annually (Exh. 53, p. 14). Moreover, the Maine Office of Public Advocates (MOPA), opine that the value of the AMI carrying charges CMP agreed to forego was $86 million. When added to the value of the acquisition adjustment, the total benefits would amount to almost $400 million. These benefits amount to 34% of CMP's annual revenues, significantly more than the approximately 11% of NYSEG and RG&E delivery revenues relied upon in calculating the PBAs here.

Moreover, in Maine, merger and acquisition transactions are approved if the total benefits flowing from the merger are equal to or greater than the detriments or risks for both ratepayers and shareholders. As a result, Maine would grant approval if a transaction resulted in no harm to ratepayers, unlike New York, where the Commission has required positive benefits to ratepayers. The detriments and risks of the transaction must have been viewed as significant to require nearly $400 million in benefits to offset and eliminate them, in order to prevent harm to Maine ratepayers.

The risks the transaction poses in New York are more significant than the risks posed in Maine. Under Maine law, the MPUC may require Iberdrola to divest the Maine delivery utility subsidiaries if the actions of the parent pose the threat of harm to those subsidiaries. No such equivalent provision is available under New York law. The Maine approval also provided for substantial ring-fencing provisions, further insulating the Maine operating utility subsidiaries from the actions of the Iberdrola parent. Despite these risk-reducing measures, substantial tangible benefits were required before Maine would approve the transaction. Similar benefits should be required here.

The petitioners may argue that Maine's circumstances are not directly comparable to those here. In particular, transmission revenues in Maine are not recognized in retail rates in the same way as they are in New York. Whatever minor ratemaking differences there might be between the two states, however, the conclusion remains the same -- Maine required substantial positive benefits before it would approve the transaction, even though the standard for approval was that the benefits were needed only to the extent they would offset risks.

c. Comparison to Energy East Benefits

The petitioners also criticize Staff's calculation of the benefits realized when Energy East was created. They claim that a proper calculation would be based on the 5-year synergy savings realized in that merger, of $164.332 million (SM 571). They also claim that this amount should be reduced by 50%, to reflect the shareholders' portion of the savings. As a result, they claim that only $82 million in benefits was achieved in the formation of Energy East.

The petitioners' comparison is misleading. The synergy savings achieved in Energy East's formation are permanent, and continue to accrue to ratepayers every year after consummation of the merger. Although these annual merger savings were shared equally between shareholders and ratepayers during the first 5-year term following the merger, after that time they are captured in their entirety for customers, for the following 5-year period. Therefore, Staff took the ratepayer share of synergy savings in the fifth year following the merger, which was $76.6 million, and multiplied that figure by five, representing the five years when all synergy savings will go to ratepayers. Using $383.5 million as the total benefit to ratepayers from the Energy East merger, as shown in Exhibit 49, is correct.

Again, the Maine analysis supports Staff's position. When Maine analyzed the synergy savings achieved upon formation of Energy East for the purposes of allocating savings to the Energy East subsidiary operating in the State, they found that NYSEG and RG&E realized a benefit of $85 million in the fifth year following the merger, a figure substantially higher than the $76.6 million assumed in 2001 when this Commission approved the Energy East merger (Exh. 54). If Maine's calculation, which is more recent and is based on figures provided by Energy East, were used as the source of the benefit calculation, it would be even higher, and would constitute an even greater proportion of the NYSEG/RG&E revenues.

D. <u>The RAP Panel Calculations</u>

The petitioners' Rate Adjustment Panel (RAP) also criticizes Staff's calculations. The RAP manufacture two calculations it says represent the effect of Staff's PBA. First, they maintain that the Staff PBA, which they characterize as amounting to $855 million, with an earnings sharing mechanism and no immediate rate reductions would create an additional $855 million in impacts over the next five years for a total of $1.7 billion. A second scenario, where rates are reduced, the RAP claims, would create an additional PBA of $784 million over the next five years, for a total of $1.69 billion (Exh. 29).

Both calculations are seriously flawed. They assume the existence of a five-year rate plan, when the term of the rate plan needed for approval of this transaction has not yet been determined. If a period shorter than five years is selected, the costs shown in Exhibit 29 are overstated concomitantly.

In addition, both scenarios begin with a mistaken PBA number. In calculating its PBAs, Staff clearly excluded from them the regulatory adjustments it believes should be made in future rate plans filed by NYSEG and RG&E. The only connection between the PBAs and the regulatory adjustments is that both are necessarily recognized when the rate plans are developed. Otherwise, they are completely separate matters. Reducing the RAP's calculations to the actual number of the PBAs, of $644 million, would substantially reduce the overall calculation.

A more reliable method to quantify the impacts of the PBAs is provided by the petitioners in their April 4, 2008 Response to On the Record Requests. On Schedule 1 there, petitioners indicate that the $201.6 in PBSs offered in the Partial Acceptance amount to $54.8 million in delivery rate reductions on an annual basis. Using that same approach, with similar assumptions, Staff has computed the value of its PBAs at

$105.2 million on an annual basis (see Attachment 2, p. 1). Therefore, the value of Staff's PBAs for a five-year timeframe would be $525 million, not $1.7 billion.

Moreover, the petitioners themselves admit that regulatory adjustments should be excluded. Petitioner Witness Meehan emphatically states that the only proper benefits realized in comparing merger costs are those benefits that cannot be achieved but for the merger (SM 952). The RAP itself also heavily criticizes Staff's regulatory adjustments.

Therefore, including the regulatory adjustments in the PBA analysis is contradictory to the petitioner's own position. Eliminating the regulatory adjustments from the RAP calculation reduces the impacts under both scenarios by almost $.5 billion. For the petitioners' Scenario I, the deletion of the regulatory adjustment amounts from the calculation has the effect of reducing the amount of fallout earnings, and thus reducing the amount of earnings sharing. Less earnings sharing also mean the accumulation of less interest on earnings sharing.

For Scenario II, as in Scenario I, the regulatory adjustment amounts should be subtracted, reducing the petitioners' rate reduction amount. Again, removal of the regulatory adjustments has the effect of reducing the amount of fallout earnings in this case thereby reducing the amount of the rate reductions the RAP calculated. As a result, Scenario II is also overstated.

Even after proper calculation, the RAP's conclusions require modification to accommodate correction of flawed assumptions. Neither scenario the RAP provided reflected the effects of earnings erosion or attrition, which the RAP admits, will occur (SM 416-18). Moreover, neither RAP scenario reflects the impact of a $60 million shortfall attributable to the expiration of a contract for the purchase of power from the Ginna plant, discussed below. When that contract expires, RG&E must expend an additional $60 million to purchase electricity on the competitive market. The impact of those greater expenditures will reduce the utility's earnings by approximately $200 million (pre-tax) over the 2008-2013 period the RAP analyzes. Along with normal earnings erosion, this impact will significantly reduce the quantification shown under the RAP's two scenarios.

Moreover, in quantifying the earnings sharing and rate reductions, the RAP has assumed an equity ratio of 38%. That ratio is much lower than any comparable ratio from recent NYSEG or RG&E Rate Plans. And its Scenario I assumes that NYSEG's electric operations are subject to earnings sharing, which is incorrect because no such mechanism is currently in place for electric rates at NYSEG. Therefore, the RAP's analysis is flawed and should not be relied upon in analyzing the PBAs Staff has proposed.

E. The Partial Acceptance Benefit Offer

Just before hearings commenced, petitioners, in the Partial Acceptance, finally conceded that some monetary benefits must be provided to ratepayers if the transaction is to obtain approval. The Partial Acceptance offers $201 million in such benefits. That dollar amount is mis-calculated and is entirely inadequate to compensate for the costs and risks associated with this transaction (SM 1456). The Partial Acceptance also offers a promise on wind power development that is illusory, and so would not be a benefit of this transaction.

1. The Monetary Offer

The $201 million amount is not even directly comparable to Staff's proposed $644 million amount. The actual benefit of the Partial Acceptance offering is substantially overstated, because petitioners assume an effective date for their PBAs of July 1, 2008, whereas Staff's PBAs take effect on January 1, 2009 (SM 1457). As of July 1, 2008, however, the costs underlying the PBAs would still be recovered in rates from ratepayers under the rate plans currently in effect at NYSEG and RG&E, and under the NYSEG Electric Order. Until the PBA costs are actually eliminated from rates, when rates are reset, the PBAs will not benefit ratepayers. Since the date, under current rate plans for NYSEG gas and RG&E electric and gas, that recognition of the benefits can begin is January 1, 2009, there are no benefits before that date. The Partial Acceptance benefits are overstated concomitantly.

The amount offered is sadly inadequate no matter how calculated. Even if no tangible benefits were required, the $201 million amount does not so much as compensate for the risks of the transaction. Those risks include the exercise of vertical market power, where even a minute difference in the hourly rate per kWh paid in NYISO markets might translate into huge windfall profits to wind developers, which will eventually be recovered from ratepayers.[43] The risks also include the financial and structural risks related to the transaction, which, in KeySpan/Grid were controlled through substantial ring-fencing measures that are not mentioned, much less acquiesced to, in the Partial Acceptance. As a result, the monetary amount offered is not even a benefit, because the risks of the transaction outweigh it. It should not be accepted as an adequate condition for this transaction.

[43] As discussed below, the Partial Acceptance does not adequately mitigate market power, which can still be exercised notwithstanding the offer to sell fossil-fueled generation plants.

2. <u>The Wind Investment Offer</u>

In the Partial Acceptance, the petitioners offer to guarantee that they will spend $100 million on the development of wind projects if the transaction is approved. This is yet another illusory benefit. The guarantee is so hedged with conditions that it is easily escaped.

Moreover, if all of the conditions hedging the offer are satisfied, Iberdrola would most likely spend the $100 million even if the transaction is not approved. It would not forego the opportunity to develop at least that level of wind projects in New York in light of the RPS and other incentives it will receive as a result.

Indeed, the cost of $100 million is but a small proportion of the value of the total wind projects Iberdrola says it now plans to develop in the State. Limiting its investment to $100 million would enable it to choose to develop only the most profitable of its potential projects. It is unlikely to forego that profit, which, given its claimed expertise in developing wind projects, should be easy for it to achieve. Therefore, the investment guarantee is of no value.

F. <u>Vertical Market Power Mitigation</u>

1. <u>Divestiture of Generation</u>

Under the VMP Statement and the KeySpan/Grid Order, the remedy to the risk of vertical market power is clear --

divestiture of generation. The VMP Statement establishes a rebuttable presumption that, if rebutted, allows for continued ownership of generation and T&D by separate affiliates in the same holding company. As discussed above, the petitioners have failed to rebut the presumption. Therefore, just as KeySpan was required to divest its Ravenswood generation facility as a condition of its acquisition, the petitioners should be required to divest their generation assets that could benefit from the exercise of vertical market power.

These assets include all of Energy East's existing gas-fired and hydro generation, and all of Iberdrola's existing ownership interests in wind projects. The petitioners should also be prevented from building any new generation in the future, except as needed to preserve system reliability after approval through the NYISO's RNA process and approval by the Commission.

2. <u>The Partial Acceptance Mitigation</u>

In the Partial Acceptance, the petitioners appear to suggest that the development of wind is inherently a market power mitigation measure, or at least adequate compensation for market power risks, because of the benefits wind generation yields. As the petitioners point out, the Commission strongly supports the development of wind resources. In this proceeding, however, Staff has acted consistent with that goal (SM 1613-14).

But, as discussed above, Iberdrola's role as a wind developer in this State adds nothing to the prospects for achieving the State's renewable generation goals. The presence or absence of just one developer in the New York State market should have little impact on reaching those goals. In that light, wind development is not a market power mitigation measure.

The petitioners in the Partial Acceptance also propose to divest themselves of all gas-fired generation. While that proposal is a positive first step, it is inadequate to mitigate vertical market power. As discussed above, the vertical market power incentives to benefit Iberdrola's wind generation by manipulating the NYSEG and RG&E T&D operations will remain the same, and New York ratepayers could be harmed by substantially overpaying for wind generation if vertical market power is exercised. The remedy therefore remains full divestiture of all Energy East and Iberdrola generating assets.

G. Financial and Structural Protections[44]

There are minimum financial conditions needed to mitigate financial and operating risks associated with the transaction, if the Commission decides to approve it. To meet that requirement Staff proposes financial conditions similar,

[44] Staff and the petitioners now agree on the security conditions needed to protect vulnerable electric and gas infrastructure, and customer privacy (SM 552, 1424).

for the most part, to those which the Commission imposed in the KeySpan/Grid Order (SM 1379). These conditions are needed in order to protect the customers of NYSEG and RG&E. The Petitioners argue these financial protections should not be applied in this case because this “transaction is significantly different than many of the transactions that have been presented to the Commission, including the National Grid/KeySpan merger” (SM 501).

Staff has demonstrated that this transaction poses many increased financial and operating risks that are detrimental to the interests of the costumers of NYSEG and RG&E (SM 1221-47). Furthermore, Staff has explained that, due to evolving circumstances such as decreased transparency and foreign ownership of domestic utilities, there is a need to impose enhanced conditions on this acquisition (SM 1354-5).

1. <u>Treatment of the Acquisition Adjustment</u>

The following conditions are needed relative to the acquisition premium Iberdrola will pay for Energy East’s stock.

1) Acquisition premium and costs associated with the pending and all past transactions will not be recorded on the books of NYSEG and RG&E or Energy East (SM 1402);

2) Acquisition premium and related costs associated with the transaction will not affect rates (SM 1402-03); and

3) Each year, Iberdrola shall provide the results of any impairment test made on goodwill (SM 1403).

Staff and the petitioners agree that the acquisition premium and costs associated with the pending transaction should not be recorded on the books of NYSEG and RG&E. There is disagreement, however, on whether the acquisition premium should be recorded on Energy East’s or Iberdrola’s books, and on the re-classification, to Iberdrola’s books, of the acquisition premium from the prior formation of Energy East in the NYSEG and RG&E merger.

It is imperative that the cost of the acquisition premium and related transaction costs should not affect rates. Even if the acquisition premium from this transaction is not recorded on the books and records of NYSEG and RG&E, depending upon where it is recorded, it could still affect the rates of these companies because the Commission will set rates using a consolidated capital structure (SM-1326-7). The goodwill from the transaction increases Iberdrola’s equity ratio, which would raise NYSEG’s and RG&E’s rates as a direct result of the transaction.

Moreover, since the increase in equity ratio would be caused by the booking of goodwill, there are no financial benefits from the higher equity ratio. To prevent the acquisition premium and related transaction costs from adversely affecting NYSEG’s and RG&E’s rates, no goodwill should not be recorded on the books of NYSEG, RG&E or Energy East. This approach is consistent with the Commission's approach when it approved the KeySpan/Grid merger, and should be implemented in this case also.

Iberdrola's goodwill should be subject to impairment analyses performed annually (SM 1314). As discussed above, the potential for impairment is substantial.

If goodwill is impaired, Iberdrola will have to write-down the goodwill on its books (SM 1313-14). If goodwill is written down, ultimately equity will be reduced by a corresponding net of tax amount. It is important that the Commission be given notice if an impairment of Iberdrola's goodwill is imminent because this will give the Commission an advance warning that problems might be developing at Iberdrola. Unless Iberdrola is required to provide the Commission with the results of its goodwill impairment testing, there is no means for the Commission to ascertain whether Goodwill is becoming a problem until it has already manifested itself as one. On the other hand, because annual impairment testing is already required under both GAAP and IFRS, this condition would not impose any additional material burdens on Iberdrola. For these reasons, Iberdrola should, as a condition of any Commission approval of this transaction, be required to provide the Commission with the results of Iberdrola's Goodwill impairment testing (SM 1403).

2. Conditions Related to Credit Quality

Staff proposes the following conditions related to credit quality:

1) NYSEG, RG&E, and Iberdrola shall maintain credit ratings on their securities from S&P and Moody's (SM 1403);

2) Iberdrola, Energy East, NYSEG, and RG&E should have a stated goal of maintaining investment grade ratings on their securities (SM 1404);

3) Copies of presentations to Credit Agencies and backups should be provided on an ongoing basis. (SM 1404-5);

4) A credit downgrade at either NYSEG or RG&E by S&P or Moody's will require the filing of a plan with the Commission to remedy the downgrade (SM 1405); and

5) In any future rate proceedings for NYSEG and RG&E, customers should not be responsible for the effect of any downgrading from their present debt ratings (BBB+/Baa1) (SM 1408).

Petitioners state that Iberdrola, Energy East, NYSEG and RG&E will maintain credit ratings with at least two generally accepted credit agencies (SM 554). They should be required to select S&P's and Moody's as the agencies for credit ratings, because they are the two generally-acknowledged leaders in the credit rating field.

Petitioners have not committed to maintaining an investment grade credit rating at Iberdrola, Energy East, NYSEG, and RG&E. This is a necessary condition precedent to any Commission approval of the proposed merger. The absence of that commitment is especially troubling because it indicates

Iberdrola lacks faith in its premise to bring “financial strength” to NYSEG and RG&E. If the petitioners cannot make this commitment, then the transaction should be disapproved.

Staff has argued that the Commission should be kept aware of what Iberdrola is telling the credit agencies about itself, Energy East, NYSEG and RG&E (SM 1404). Access to presentations to credit agencies would give the Commission insight to the future planning and capital needs of both Iberdrola and its jurisdictional utilities (SM 1404). Access to these reports would also give the Commission greater insight into whether there is any financial threat to its jurisdictional utilities is on the horizon (SM 1404). Iberdrola, however, has committed only to giving the Commission slide presentations to credit ratings agencies relating to Energy East, and rating agency reports relating to Energy East, or any Energy East subsidiaries (SM 554).

Iberdrola’s proposal does not go far enough. It is important for the Commission to have the complete picture of the credit quality of Iberdrola since, ultimately, it will finance the operations of NYSEG and RG&E. It would be of little use for the Commission to know that NYSEG and RG&E are performing well if other operations of Iberdrola are performing poorly and might drag down the credit quality of the whole Iberdrola family. Therefore, any approval of this transaction should be conditioned upon Iberdrola's keeping the Commission fully informed of any presentations made by Iberdrola to credit agencies, to ensure the Commission remains apprised of all aspects of the operations of Iberdrola, as well as its New York State-jurisdictional utilities.

Any credit downgrade of either NYSEG or RG&E by S&P or Moody's should require the filing of a plan with the Commission to remedy the downgrade (SM 1405). The condition proposed by Staff is no more stringent than that which the Commission imposed in the KeySpan/Grid Order (SM 1405).

Petitioners offer that, in the event of any downgrade of Iberdrola, Energy East, NYSEG, or RG&E credit ratings below "BBB"/"Baa3", or credit rating of "BBB"/"Baa3" with a "Watch Negative", by at least two major credit reporting agencies, NYSEG and RG&E would make a timely filing notifying the Commission of any such Credit Event, and subsequent filings with the Commission every three months, identifying (1) the current credit rating of the Company in question and (2) a plan to remedy the downgrade or credit watch until the downgrade/credit watch is eliminated (SM 554).

Given the KeySpan/Grid Order, the petitioners proposed condition is insufficient. Whenever a credit downgrade by S&P or Moody's of either NYSEG or RG&E occurs, the filing of a plan with the Commission is needed so that it can remedy the downgrade and its consequences (SM 1405).

In any future rate proceedings for NYSEG and RG&E, customers should not be held responsible for the effect of any downgrading of NYSEG or RG&E from their present debt ratings (BBB+ and Baa1, respectively) (SM 1408). Petitioners, on the other hand, take the position that NYSEG and RG&E ratepayers shall not be responsible for any increase in NYSEG’s or RG&E’s cost of debt that is caused by Iberdrola’s financial status (SM 554).

Petitioners’ offer is inadequate. The condition recommended by Staff is no more stringent than that which was imposed in the Grid/KeySpan merger case (SM 1408).

The condition proposed by Staff would create a strong incentive for Iberdrola to take effective measures to remove NYSEG and RG&E from their current negative outlook, and would provide Iberdrola with an opportunity to demonstrate, in a tangible way, that its financial strength and best practices will benefit the ratepayers of NYSEG and RG&E. In contrast, Iberdrola’s counter-proposal would be very difficult to administer and enforce because it would require a finding that the increase in NYSEG’s or RG&E’s cost of debt is “caused” by Iberdrola’s “financial status.” Making such a finding would engender dispute and delay, when instead prompt action is required to respond to a downgrade.

The credit quality of Iberdrola, Energy East, NYSEG and RG&E is of concern. If this transaction is approved, it should be subject to conditions that provide the Commission with complete, clear, and timely information about Iberdrola, NYSEG, and RG&E, and commitments to maintain the investment grade credit quality of Iberdrola and its New York jurisdictional utilities.

3. Conditions Related to Dividend Restrictions

Staff proposed the following conditions related to dividend restrictions:

1) For each company, the amount of dividends NYSEG and RG&E could send upstream to Iberdrola should be limited during the year to no more than the sum of the income available for common equity, plus the cumulative amount of retained earnings since the acquisition was consummated, plus the portion of additional “paid in capital” that is recorded on the books of NYSEG and RG&E as unappropriated retained earnings and unappropriated undistributed earnings less accumulated other comprehensive income existing immediately prior to the consummation of the acquisition, to the extent such earnings had not already been paid out as a dividend (SM 1406-7);

2) NYSEG and RG&E should each be prohibited from paying a dividend at any point in time when its least secure unsecured bond rating is at the lowest investment grade and a rating agency has issued outstanding negative watch or review downgrade notices (SM 1407);

3) NYSEG and RG&E should each be prohibited from paying a dividend if Iberdrola’s least secure senior unsecured debt is rated below an investment grade by a rating agency (SM 1407);

4) NYSEG and RG&E should each be prohibited from paying a dividend if their respective bond ratings are immediately downgraded to the non-investment grade category (SM 1407-08); and

5) When under a dividend restriction, NYSEG and RG&E should not be permitted to transfer, lend or lease any items of value to any affiliate without prior Commission approval (SM 1408).

Petitioners note testimony that Iberdrola's dividend policy is an integral part of its Strategic Plan 2008-2010, which has been taken into account by the credit agencies as part of the larger credit analyses that led to Iberdrola's "A" category credit ratings (SM 510). Petitioners further state that it is their understanding that the Commission has not required dividend restrictions of the kind proposed by the Staff Policy Panel in any non-synergy transaction in New York in the past 11 years (SM 555-6). Notwithstanding their position that dividend restriction conditions are unnecessary, petitioners pledge that NYSEG and RG&E will maintain their respective dividend policies with due regard for the financial performance and needs of NYSEG and RG&E, irrespective of the financial performance and needs of Iberdrola. Further, petitioners commit that Iberdrola will report to the Commission in the event that the dividend payout for any year is more than 100% of income available for dividends calculated on a two-year rolling (eight calendar quarter) average basis (SM 557).

These commitments do not go far enough to protect the financial health of the utilities. More rigorous dividend restrictions are necessary to prevent Iberdrola from draining the capital of NYSEG and RG&E in the event of unforeseen circumstances that create financial difficulty at Iberdrola, or if Iberdrola simply decides to enhance its dividends to its shareholders (SM 1405-6).

Petitioners’ assertion that dividend restrictions are not needed because the credit agencies considered Iberdrola’s Strategic Plan 2008-2010 before giving Iberdrola an “A” category credit rating displays a lack of understanding of the purpose and intent of dividend restrictions. Such restrictions are relevant not when Iberdrola’s credit rating is at investment grade, but instead become necessary when the parent, or NYSEG or RG&E, are in financial difficulty. Dividend restrictions are a means of ensuring that cash is conserved during difficult times. The dividend restrictions which Staff proposes would be a permanent provision that should remain in place as long as Iberdrola or any successor holding company is the ultimate parent of NYSEG and RG&E.

Petitioners’ argue that the Commission has not required dividend restrictions in any non-synergy transaction in New York in the past 11 years. Petitioners do not explain, however, why the presence or absence of synergy savings should have any bearing on whether dividend restrictions are appropriate. Moreover, as discussed above, the water company mergers cited by the petitioners are readily distinguishable, given the circumstances unique to that industry (SM 940-2).

This merger should instead be judged by a comparison to other energy industry mergers in New York. In the energy mergers approved by the Commission in recent years, and in this transaction as well, the acquired jurisdictional companies' access to capital has not been an issue. Nonetheless, the Commission has been clear that dividend restrictions are necessary in energy mergers. The restrictions which Staff proposes here are fully consistent with the dividend restrictions that the Commission imposed in the KeySpan/Grid Order, and are essential to protect customers against the risk of Iberdrola draining cash out of NYSEG and RG&E.

4. <u>Conditions Related to Money Pool Arrangements</u>

Staff proposed the following rules for money pool transactions:

1) NYSEG, RG&E and any future domestic regulated entities may participate in a money pool arrangement as a borrower or lender (SM 1409);

2) Iberdrola may participate in a money as a lender only (SM 1409);

3) Non-regulated or foreign entities may not participate in a money pool with NYSEG or RG&E (SM 1409);

4) No cross default provisions for any affiliate of Iberdrola which affect NYSEG and RG&E and promise that

Iberdrola and its affiliates will not enter into such arrangements in the future (SM 1410); and

5) Indirect loans from NYSEG and RG&E to any affiliate are prohibited (SM 1409).

Petitioners generally accepted these conditions (SM 556-7). They were silent, however, on Staff's condition that indirect loans from NYSEG and RG&E to any affiliate are prohibited. The intent of Staff's condition is to close any circumvention of the money pool rules by ensuring that monies lent to other utilities stay within the utility family.

Petitioners would modify Staff's cross-default condition. Under their proposal, there would be no cross-default provisions in any joint-credit arrangements by and among NYSEG and RG&E, or by and among Iberdrola and its affiliates, unless authorized by the Commission (SM 556).

Petitioners' proposal should be rejected. In the KeySpan/Grid Order, the Commission approved the cross-default language Staff has proposed here. Staff's recommendation would provide customers more protection, from petitioners' proposal, from the risk of a cross-default affecting NYSEG and RG&E. Given the complexity of Iberdrola's corporate structure, Staff views this as an essential condition to any approval of the proposed transaction.

5. Corporate Structure Protections

Staff proposed the following conditions related to structural protections:

1. A golden share should be required in order to prevent any bankruptcy of Iberdrola, or any of its affiliates, from triggering a voluntary bankruptcy of NYSEG or RG&E (SM 1417); and

2. An LPE should be imposed in order to ensure compliance with dividend and money pool restrictions (SM 1417-8).

a. Staff's Golden Share Arguments

While Staff has recommended financial conditions, the concern remains that these conditions alone would not be sufficient to protect the credit quality of NYSEG and RG&E should Iberdrola or one of its affiliates encounters bankruptcy. S&P's has concluded that stand-alone financial conditions, which are among the conditions recommended by Staff, "do not go far enough in effectively insulating or ring-fencing the subsidiary from its parent" in the event of bankruptcy or fiscal distress (SM 1410-1). According to S&P, courts rarely compel an entity to comply with the terms of its covenants (SM 1411). Moreover, S&P also cautions that, "management will, in keeping with its responsibilities to shareholders, attempt to find ways to defeat covenants that are burdensome" (SM 1411).

S&P states that a subsidiary is generally constrained to three credit notches (one full bond rating category) above the credit quality of the consolidated entity (SM 1412). S&P

has also stated that a package of enhancements that include financial covenants and structural features might be enough to achieve this goal (SM 1412).

The particular corporate structural feature that S&P singles out for discussion is a limited purpose entity (LPE) whose existence is premised on performing one specific task (SM 1413). In this instance, the LPE would act as a shield against bankruptcy between the New York jurisdictional utilities and Iberdrola and its affiliates. An LPE is permanent and cannot be terminated or merged into another entity (SM 1413). The most important feature of an LPE is that it has a director that is independent from the parent company and would have the public interest of the subsidiary as its primary focus (SM-1414). Given that its duty to the public would be a condition of its charter, it is unlikely that an LPE subsidiary would ever be placed voluntarily into bankruptcy as a result of the actions of its parent.

b. <u>Petitioners' Golden Share Arguments</u>

Petitioner Witness Makholm asserts that the golden share is redundant and unnecessary (SM 1099). He argues that "modern measures for dealing with affiliate transactions are sufficient to deal with the protection of ratepayers" (SM 1099). The Joint Petitioners further assert that requiring the issuance of a golden share would, by imposing a new layer of corporate governance, impose unnecessary costs. They further assert that, given its novelty, both in New York and in U.S. utility regulation generally, requiring a golden share could have consequences that cannot be predicted and would generally create uncertainties for Iberdrola (SM 1099).

Petitioners also claim that Staff's idea "that NYSEG or RG&E would voluntarily declare bankruptcy at the behest of Iberdrola, so that Iberdrola could 'siphon assets out of its financially healthy subsidiary' simply is nowhere near a realistic possibility" (SM 1099-1100). Further, they claim there is no basis for believing that declaring bankruptcy could erode the protections for ratepayers or work to benefit the equity owners of the utility operating companies (SM 1100). Witness Makholm also argues that the protections Staff advocates are unnecessary because there is little risk of any bankruptcy of NYSEG or RG&E; he claims only four investor-owned utility bankruptcies have occurred since the Great Depression (SM 1102).

As discussed above, Witness Makholm's positions on bankruptcy and the golden share are wholly unpersuasive. In addition, S&P finds that a weak parent has the incentive and the ability to siphon funds from a utility subsidiary (SM 1417), and that the golden share is a valuable tool to protect utility subsidiaries from a weak parent (SM 1412-03). While Iberdrola is of investment grade today, that is no guarantee of future performance. In contrast, a golden share effected through an LPS is permanent (SM 1413), and always present if the financial health of Iberdrola were to deteriorate.

Contrary to petitioners' claim, there is little or no administrative cost in establishing and maintaining the cost of the golden share. In the KeySpan/Grid Order, the Commission ordered the establishment of a golden share in order to prevent a bankruptcy of National Grid or any other affiliate from triggering a bankruptcy of KEDNY or KEDLI. It is telling that both major credit agencies praised the ring-fencing provided for in these mergers (SM 1478). Moreover, in the Maine proceeding on the Energy East acquisition, Iberdrola stipulated to ring-fencing and divestiture provisions for the Maine utilities that were acquired (SM 1145; Exhs. 51, 52).

c. The Golden Share Remedy

To implement a "golden share" in this proceeding, NYSEG and RG&E should each be ordered to file a petition seeking authority to establish a class of preferred stock having one share, subordinate to any existing preferred stock, and to issue such share of stock to a party, to be determined by the Commission, who would protect the interests of New York and would be independent of the parent company and its subsidiaries. The "golden share" voting rights, would limit NYSEG's and RG&E's right to commence any voluntary bankruptcy, liquidation, receivership, or similar proceedings without the consent of the holder of that share of stock.

d. The Other Uses of an LPE

The Commission should also consider using an LPE as an instrument for ensuring compliance with dividend and money pool restrictions (SM 1417). An LPE, controlled by an independent director, that acted as a conduit of funds, both paper and electronic, would more effectively enforce dividend and money pool restrictions if they are triggered, assisting in assuring that monies remain at the utility in times of financial stress. This vehicle would deepen structural separation between Iberdrola and its subsidiaries, enhancing the credit quality of Iberdrola’s utility subsidiaries (SM 1411-12).

G. Structural Conditions

Should the Commission decide to approve this acquisition, numerous structural conditions are needed to protect the customers of the New York utilities. These include restrictions on transactions between the utilities and affiliates to prevent improper cross-subsidization, a more contemporary code of conduct, and enhanced financial reporting and access requirements.

The essential protections proposed by Staff are forward-looking and designed to protect consumers from potential abuses associated with Iberdrola. A larger, more distant, less transparent, more diversified, and more complex acquiring organization. Without these conditions, there are significant concerns that consumers will be harmed. For example, as discussed above, the incentives to cross-subsidize and inflate costs under the Iberdrola organization will be dramatically different than incentives under Energy East (SM 1355).

1. The SPE Risk

The number and scope of Iberdrola's unregulated subsidiaries, and the complexity of its organizational structure, make it difficult to accurately evaluate its financial strength and capitalization, even under the best of circumstances (SM 1246). Iberdrola's corporate structure includes numerous Special Purpose Entities (SPEs), which potentially could cloak the true financial position of a utility holding company. SPEs are subsidiaries that are created to fulfill narrow, specific or temporary objectives, primarily to isolate financial risk, usually the potential for bankruptcy, but sometimes a specific taxation or regulatory risk (SM 1348-49).

Staff is troubled by the history of SPEs. They have been used in the past by companies like Enron in complex financial schemes to avoid taxes and manipulate financial results (SM 1349). While, under both GAAP and IFRS, a number of accounting standards apply to SPEs (SM 1350), the presence of

SPEs on Iberdrola's books lends a complexity to Iberdrola's operations that potentially could make assessing the true financial position of Iberdrola, and future ratemaking, more difficult.

2. Reporting Requirement Charges

There have been multi-dimensional changes to the financial reporting of holding companies, which have diminished the transparency of holding companies (SM 1240). While Staff acknowledged that most changes have no connection to the proposed acquisition (SM 1240), the changes in reporting have a direct bearing on the future transparency of the combined companies (SM 1240). Indeed, the complexity of Iberdrola's operations is one reason why the financial statements of Iberdrola and its affiliates should be presented in U.S. GAAP.

For example, under Public Utility Holding Company Act of 2005 (PUHCA 2005), Energy East is no longer required to provide the same level of detailed holding company financial reports (SM 1241). Those reports were replaced by the streamlined FERC holding company financial report (FERC Form 60) (SM 1240). Moreover, since the New York utilities no longer have outstanding publicly-traded securities, they are no longer required to file their own individual detailed SEC reports, such as the Form 10-K annual and the Form 10-Q quarterly reports (SM 1240-1). Other utility holding company financial statements formerly required by the SEC no longer need be filed, including SEC Form U-5S and portions of SEC Form U-9C-3 (SM 1343).

Form 10-K contains information on many financial and accounting matters that are valuable to investors and regulators alike (SM 1343). SEC Form U-5S presented the consolidating balance sheet of the parent company and the capitalization ratios of the parent company's direct subsidiaries. This balance sheet showed the extent to which capital reported by a subsidiary as common equity is eliminated at the consolidated holding company level because it is actually funded with some other form of holding company capital, such as debt or preferred stock (SM 1344). SEC Form U-9C-3 contained balance sheets for each of Energy East utility and non-regulated energy subsidiaries (SM 1344-5).

Staff used the information in Form U-5S and Form U-9C-3 to analyze whether the equity ratio requested by utility subsidiaries of holding companies should be adjusted. This analysis is based on three considerations (SM 1345).

The first consideration is to determine if the common equity balance requested by the utility subsidiary is actually financed by debt issued at another level within the holding company (SM 1345-6). This is an important consideration for NYSEG and RG&E because failure to adjust for such fictitious equity will produce windfall profits within the holding company.

The second consideration is to determine if the common equity ratio requested by the utility subsidiary is consistent with the ratios of other utility subsidiaries of the holding company (SM 1346-7). For example, it would be unreasonable to set the rate of return of a New York subsidiary based on a stand-alone equity ratio when the ratios of other utility subsidiaries were substantially lower. In those circumstances, ratepayers in New York would make a disproportionately larger contribution to the holding company's overall earnings than ratepayers in other jurisdictions.

The third consideration relates to the sources of the financing the holding company and other affiliates use to support their non-utility investments. Such investments typically entail greater risk than utility operations and therefore require greater amounts of common equity to properly serve as a buffer for the earnings volatility that comes with the greater risk (SM 1347).

As discussed above, Iberdrola has large investments in unregulated business ventures and has large amounts of risky goodwill recorded on its books. These assets must be financed with the proper mix of debt and equity (SM-1347). Without this information, Staff would not have capital structure information about the relevant Iberdrola business entities sufficient to support development of a proper ratemaking capital structure.

One of the important oversight activities the SEC provided was comprehensive audits of utility holding companies (SM 1241). It appears FERC will continue the holding company audit program, but it is not clear that the audits will be in the same depth or frequency as the former SEC audits, or if this Commission will be asked to participate in them (SM 1241).[45] The weakening of those audits is a concern, especially if larger, more complex international holding companies become more prevalent in New York. Staff's main concern is that other checks and balances that were in place years ago have either been removed or substantially weakened (SM 1241-2).

3. The Effect of the Transaction Reporting

This transaction might further impede the reporting of information. Financial accounting under U.S. Generally Accepted Accounting Principles (GAAP) would cease and would be replaced by International Financial Reporting Standards (IFRS) for Iberdrola (SM 1242). Iberdrola may be made more opaque if it does not file audited public statement under U.S. GAAP (SM 1243-4). For example, Exhibit 95 is a publication dated October 2007

[45] The US General Accounting Office (GAO) (see GAO Report 08-289) indicates that, due to limited resources, FERC will conduct roughly half of the audits the SEC formerly performed. "FERC planned to conduct affiliate transaction audits of 3 companies in 2008 (of the 36 holding companies it regulates). (GAO Report page 8). "In overseeing affiliate transactions in recent years, SEC audited each holding company about every 6 years" (GAO Report page 4).

by PricewaterhouseCoopers entitled “Similarities and Differences-A comparison of IFRS and US GAAP” summarizes the many differences between IFRS and US GAAP (SM 1243). Exhibit 96 (“Moody’s reports: European Electricity Producers’ financials lack key data” dated October 30, 2007) documents Moody’s recognition of the shortcomings of IFRS reporting. Specifically, Moody’s stated “the usefulness of Europe's Electricity Producers' financial statements would be significantly enhanced if the companies provided more information about their electricity generation activities and power plants” (SM 1244). As detailed at Exhibit 97,[46] Moody’s notes that only two of the eight companies disclose the profit they derive from producing electricity (SM 1244-5; Exh. 97, p. 4). Moody’s states “Electricity generation is a significant activity for these companies, but it is difficult to compare performance when they adopt different approaches to segment reporting” (SM 1245). Staff concludes that significant differences remain between IFRS, governing Iberdrola, and GAAP, which is used in the U.S. Such differences in reporting standards create the potential for the misinterpretation of Iberdrola’s financial statements. Compliance by Iberdrola and its affiliate’s with U.S. GAAP would resolve this issue.

[46] Moody's "Europe's Electricity Producers -- Is Comparability Compromised by Different Accounting Practices? (October 2007).

Staff notes that Energy East will no longer be subject to the Sarbanes-Oxley Act (SOX) after the M&A transaction is consummated (SM 1246). SOX established stronger standards for all U.S. public company boards, managements, and public accounting firms. These standards are backed by criminal penalties for noncompliance.

SOX requires that the officers of Energy East attest, in periodic statutory financial reports, that: 1) the signing officers have reviewed the report; 2) the report does not contain any material untrue statements, or material omissions that could be considered misleading; 3) the financial statements and related information fairly present the financial condition and the results in all material respects; 4) the signing officers are responsible for internal controls and have evaluated these internal controls within the previous ninety days and have reported on their findings; 5) the financial reports include a list of all deficiencies in the internal controls and information on any fraud that involves employees who are involved with internal activities; and 6) the financial reports identify any significant changes in internal controls or related factors that could have a negative impact on the internal controls (SM 1245-6). If Energy East is no longer subject to the requirements of SOX, there may be a reduction of internal controls and regulatory oversight due to the loss of

SOX protections (SM 1246-7). Furthermore, since ratepayers have already funded the costs of SOX compliance in rates, the utilities will keep those amounts until rates are re-set, even though SOX protections will no longer be available. As a condition of the approval of this transaction, therefore, the officers of Energy East should remain accountable to SOX regulations and should file such attestations with the Commission.[47]

4. Staff's Reporting Requirements

In summary, Staff is concerned that there will be a significant reduction in the Commission's ability to acquire a complete picture of Iberdrola's operations because of the company's status as a foreign holding company operating under IFRS rules, and because of the repeal of the Public Utility Holding Company Act of 1935 (PUHCA). Staff should have access to the books and records of Iberdrola and its majority-owned affiliates in English and these books and records should be made available in New York State. NYSEG and RG&E should continue to meet their current reporting requirements. This will provide Staff with access to information needed to regulate NYSEG and RG&E. Energy East should continue to be subject to the legal

[47] Petitioners concession, that "Energy East will continue to use U.S. GAAP for all financial reporting and will comply with existing and any applicable requirements of the Sarbanes-Oxley Act" (SM 548-49), should be made an explicit condition of merger approval.

requirements of SOX. Periodic statutory financial reports should include certifications by Energy East officers of the six SOX requirements described above.

Staff recommends that Energy East, NYSEG, and RG&E remain subject to annual attestation audits by independent auditors (SM 1434). This will provide some confidence that the financial statements of these entities fairly reflect the financial condition of the companies. Finally, we recommend that the Commission require Iberdrola to provide annual public financial information, including consolidating balance sheets, income statements, and cash flow statements, a comprehensive management discussion of results consistent with Energy East’s current 10-K concerning Iberdrola, and financial information about each of Iberdrola’s regulated and unregulated energy companies operating in the U.S (SM 1434-45). Such filings should reflect audited U.S. GAAP financial statements in U.S. dollars (SM 1435).

The consolidated statements will illustrate how each of Iberdrola’s major regulated and non-regulated subsidiaries contribute to the overall consolidated financial statements. This information should be in the same format as the consolidated financial statements contained in SEC Form U-5S that registered utilities had been required to file under the Public Utility Holding Company Act of 1935 (PUHCA)(SM 1435).

The energy utility information should be fully consistent with SEC Form U-9C-3, which registered holding companies had been required to file under PUHCA (SM 1435-6).

Staff also recommends that, as a condition to any approval of the proposed merger, Iberdrola be required to file consolidated balance sheets, income statements and cash flow statements for Energy East and its direct subsidiaries in English, using U.S. GAAP, in all future rate cases (SM 1436). This information should be provided for the historic test year and be projected to the future rate year. In support of these forecasts, NYSEG and RG&E should also be required to file balance sheets, income statements and cash flow statements for all Energy East's subsidiaries that are either utilities or operate in the energy business for the historic test year (SM 1436).

These recommended conditions assure that Staff and the Commission will have sufficient information to properly analyze NYSEG and RG&E's capital structure in order to assure that its rates are just and reasonable. Staff’s recommendation adds to the reporting requirement on the companies beyond those imposed by other regulators, but it should not be too cumbersome as Energy East has previously filed this information through former SEC Forms U-5S and U-9C-3, and the costs of such requirements are embedded in rates.

5. Petitioners' Reporting Arguments

Differences in accounting standards and language, coupled with Iberdrola's much more complex organizational structure and the unfamiliarity of Iberdrola with New York's regulators and their policies, all pose a risk to the customers of NYSEG and RG&E. Petitioners believe these concerns are unfounded (SM 548). They claim that Staff ignores the track record of other stable and successful foreign utility investments in the United States; for support, petitioners cite UWC, AWW, Niagara Mohawk and KeySpan (SM 548). The petitioners state that Iberdrola will continue to comply with all U.S. laws and regulations regarding financial reporting, and note that U.S. GAAP and the IFRS are high-quality accounting standards that are similar in many respects and are rapidly converging (SM 548).

In place of Staff's conditions, petitioners propose several, less important conditions.[48] While Staff accepts certain of these proposed conditions, many do not go far enough, or require clarification.

[48] Certain proposed commitments do not require comment because they are required by law, rule, or regulation. An example is the statement that "the Commission will have access, in English and in New York, to (1) the books/records of NYSEG and RG&E" (SM 549).

The petitioners have stated that they are willing to commit to the following financial transparency and reporting measures:

1) Energy East will continue to use U.S. GAAP for all financial reporting and will comply with existing and any applicable requirements of the Sarbanes-Oxley Act.

2) The Commission will have robust access, in English and in New York, to...any books/records of Iberdrola or any Iberdrola affiliates that are related to NYSEG or RG&E. The Commission will have access, in English and in New York, to any minutes of the Iberdrola Board of Directors, and any sub committee thereof, to the extent that such minutes discuss Energy East, NYSEG or RG&E. Iberdrola also shall translate such other documents as the Commission determines to be reasonably necessary to fulfill its statutory duties.

3) The Commission will have access, in English and in New York, to all internal and external audit reports and recommendations for NYSEG and RG&E, and for any Iberdrola affiliate with respect to the provision of goods and services for compensation to NYSEG or RG&E.

4) Iberdrola’s consolidated balance sheets, income statements and cash flow statements will be made available to the Commission, in English and in New York, on an annual basis and in a format that is mutually agreed to between Iberdrola and the Commission Staff.

5) Audited financial statements will be in accordance with IFRS as, as [sic] issued by the International Accounting Standards Board, consistent with SEC requirements. Additionally, Iberdrola agrees to provide specific answers to particular questions raised by the Commission and its Staff with respect to IFRS (SM-548-50).

Staff accepts the first commitment; however, it omits certain necessary reports (which will be discussed below). The second commitment is too narrow because it is limited to

"Iberdrola affiliates that are related to NYSEG or RG&E." The third commitment is too narrow because it is limited to "Iberdrola affiliate[s] with respect to the provision of goods and services for compensation to NYSEG or RG&E." The final commitment, insofar as it refers to the provision of information "in a format that is mutually agreed to between Iberdrola and the Commission Staff" is unduly vague. Moreover, Staff requested that Iberdrola's consolidated balance sheets, income statements and cash flow statements be made available to the Commission, in English and in New York, on a U.S. GAAP basis, not on an IFRS basis.

With respect to financial reporting, Iberdrola should be required to provide information that is in the same format as SEC Form 10-K, SEC Form U-5S, and SEC Form U-9C-3 and prepared under U.S. GAAP, to ensure that the information is presented in a clear, accurate manner. Iberdrola's offer to answer the Commission's and Staff's questions regarding IFRS does not go nearly far enough. Financial information should be provided in U.S. GAAP, a format familiar to the Commission and its Staff.

Iberdrola's commitments do not adequately address Staff's concerns about financial transparency and reporting. The Commission needs complete access to the books and records of all Iberdrola affiliates in order to adequately audit the affiliated transactions of NYSEG and RG&E, including unrecorded and chained transactions and indirect loans. Because the Petitioners' commitments are insufficient to provide the Commission with the information needed to carry out its statutory duties, any Commission approval of the proposed transaction should be conditioned upon Staff's recommendations.

H. The Code of Conduct

Staff proposed a number of enhancements to the Code of Conduct (SM 1427-32), and incorporated those in a revised Code (Exh. 111). These affiliate transaction standards govern relationships between the regulated utilities and competitive energy affiliates, access to books and records of affiliates, transfers of assets, personnel matters, royalties, sales and purchases between affiliates and the utilities, financial protections, and cost allocations (SM 1425). Staff reasoned that "the existing affiliate transaction rules were designed to and seem adequate to govern the somewhat straightforward relationship between Energy East holding and service companies, NYSEG, and RG&E. However, in the post-Iberdrola acquisition environment they are inadequate since they may not be able to capture the nuances and unknowns related to the future dealings between Iberdrola, Energy East, and the utilities" (SM 1425-26). The revised standards should apply to all existing entities and to any entity which is owned 10% or more, directly or indirectly, by Iberdrola or effectively owned more than 10% by

Iberdrola when combined with other Iberdrola ownership interests (SM 1426).

The revisions include the following. Staff proposed to prohibit any affiliate from using the same name, trade names, trademarks, service name, service mark or a derivative of a name, of the utilities or in identifying itself as being affiliated with the utilities (SM 1427), and that “unregulated affiliates are prohibited from giving any appearance that they represent the DISCO in matters involving the marketing of services by the DISCO or other affiliates” (SM 1428). This will prevent Iberdrola and its affiliates from gaining an unfair competitive advantage over its competitors. In addition, the management corporation that receives customer information must promise the utility, in a legally binding document, executed by authorized personnel and specific to each transmission of information, that it will not disclose the information. The utility should be required to make each such document available to Staff (SM 1428-29).

Under the Code of Conduct, transfers of goods or services to the utilities should be at the lower of actual cost or market price and transfers to affiliates should be at the higher of cost or market. In order to prevent chaining, costs for purposes of the affiliate’s transfers to the utilities should be limited to the original acquisition costs incurred by the first non-regulated affiliate (SM 1429).

Petitioners reject all of Staff's proposed changes to the existing code of conduct. They argue that "the existing affiliated transaction rules are adequate to govern the relationship between Energy East holding and services companies, NYSEG, and RG&E" (SM 561).

Petitioners, however, would commit to the following measures to ensure further that there are no potential incentives for cross-subsidization among NYSEG, RG&E and Iberdrola's unregulated affiliates.

1) NYSEG and RG&E will continue to utilize Energy East's cost allocation methodologies and Energy East will allocate centralized costs from Iberdrola to NYSEG or RG&E only to the extent that such costs are properly chargeable to utility operations and accepted by the Commission.

2) NYSEG and RG&E will not transfer or sell material assets or facilities to Iberdrola or any affiliate without prior approval of the Commission. All asset sales to these entities will be on an arm's-length basis, and be subject to market vs. book value tests.

3) Acquisition Premium - NYSEG and RG&E will not seek recovery of the acquisition premium being paid by Iberdrola in the Proposed Transaction, either directly or indirectly, from customers in any proceeding.

4) Transaction Costs - NYSEG and RG&E will not seek recovery in rates of any transaction costs for the Proposed Transaction in any proceeding. Transaction costs include investment bank fees, legal fees, transfer or other taxes, severance or change of control related payments, incremental costs for stock options and restricted stock and any other costs

incurred either to complete or as a result of the Proposed Transaction (SM 559-62).

Staff rejects the first commitment; it does not do enough to protect consumers from potential cross-subsidization. As Staff demonstrated, since Iberdrola has not provided any synergy savings in this acquisition, and the utilities are already paying for and receiving all necessary services from existing domestic holding or service companies, it would not be appropriate to permit Iberdrola to impose service company cost allocations on U.S. utility affiliates (SM 1230-31).

Staff accepts the second commitment. As discussed above, however, Staff does not accept the third commitment, on acquisition premium, because it does not go far enough. The final commitment is vague and burdensome; it must be clarified, and the qualifiers eliminated, so that no transaction costs will ever be reflected in rates or earnings sharing.

It should be noted that transaction costs are a risk of Iberdrola's acquisition of Energy East. Although the petitioners protest that their commitment to not seek recovery of transaction costs is easily verified, verification is not so readily accomplished (SM 1254-58). Disputes may arise over what does and does not constitute a transaction cost. The petitioners refuse to commit to a definition, making future disagreements over this issue, if not likely, certainly possible Therefore, transaction costs are yet another example of how this acquisition creates risk for ratepayers even though they receive no benefits.

Therefore, the Code of Conduct and other commitments petitioners propose are inadequate. Staff's Code of Conduct revisions should be adopted instead, along with, however, the petitioners' second commitment.

V. RATE PLAN ISSUES

In the KeySpan/Grid Order, the Commission made determinations affecting the development of rate plans for the T&D utilities that were being acquired as a result of the merger transaction under review there.[49] The Commission should follow a similar process here, deciding the rate plan issues that were litigated in this proceeding, if it approves the Iberdrola-Energy East transaction subject to conditions. Prompt implementation of rate plans should ensure that any benefits obtained as conditions to approval would be realized by ratepayers.

If approval of the transaction is granted upon a requirement that monetized benefits be provided, new rate plans for NYSEG and RG&E must be implemented enacted to insure those benefits are translated into lower rates. Moreover, new rate plans are needed because NYSEG and RG&E are currently over-earning. Using the proposed PBAs together with the regulatory

[49] KeySpan/Grid Order, p. 156.

adjustments proposed by Staff, NYSEG's electric and gas delivery rates are overstated by $41.8 million and $18.4 million, respectively (see Exhs. 123-124 revised). Similarly, RG&E's electric and gas delivery rates are overstated by $103.9 million and $13.6 million, respectively (see Exhs. 119-120 revised). Finally, the new rate plans must confront any upward pressure on rates that could result in rate increases in the future.

The rate plans for NYSEG gas, RG&E electric and RG&E gas expire on December 31, 2008.[50] A rate plan is not currently in effect for NYSEG electric, but its rates were re-set in 2006 in the NYSEG Electric Order, supra. Therefore, new rate plans for all four operating subsidiaries could take effect as of January 1, 2009.[51]

In compliance with the RG&E Rate Plan Order, RG&E has filed, on February 1, 2008, a request to continue its Rate Plan beyond its December 31, 2008 expiration date. That request should be superseded by any decision on future rate plans

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[50] Case 03-E-0765, et al., Rochester Gas and Electric Corporation – Rates, Order Adopting Provisions of Joint Proposals With Conditions (issued May 20, 2004) (RG&E Rate Plan Order); Case 01-G-1668, New York State Electric & Gas Corporation – Gas Rates, Order Establishing Rates (issued November 20, 2002) and Order Concerning Rate Design, Economic Development, and Affordable Energy Programs (issued September 23, 2004)(NYSEG Gas Order).

[51] An overview of the NYSEG Electric Order and the NYSEG Gas Order are presented at SM 1722-29; a similar review of the RG&E Rate Plan Order is presented at SM 1648-54.

reached here. Moreover, petitioners at several points in their testimony complain that modifying the rate plans would unreasonably disturb the terms and conditions the Commission ordered in them. Because, however, Staff proposes that new rate plans commence only as of January 1, 2009, after the existing rate plans have expired on December 31, 2008, an issue of interference with existing rate plans simply does not exist here. Moreover, the rate plans contain provisions that allow the Commission to act should the rates become unjust or unreasonable.[52] As a result, the Commission could require rate reductions before the rate plans expire.

The rate plans should be structured so that new rates are in place by January 1, 2009, when the current rate plans for NYSEG Gas, RG&E Gas, and RG&E Electric would otherwise end. If there is not sufficient time to develop rate plans between the issuance of a Commission decision and January 1, 2009, existing rates should be made temporary as of that date, subject to refunds that reflect Staff's positions here, by Staff. A second option would be to implement, as of the January 1, 2009, the lower earnings sharing thresholds Staff recommends below. In either event, an expedited rate proceeding should be concluded as soon after January 1, 2009 as is feasible.

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[52] NYSEG Gas Rate Joint Proposal, §XXXI.7.b.; RG&E Electric and Gas Rate Joint Proposals, §§XXII.6.b.

A. The PBA Adjustments

In order to create the tangible monetary benefits necessary to justify approval of the transaction, Staff has proposed, as explained above, Positive Benefit Adjustments (PBAs) that would be reflected in its rate plans. As quantified by Staff, the PBAs are comprised of a combination of regulatory assets that would be eliminated and regulatory reserves, that would be increased, reducing additional funding from ratepayers that might otherwise have been required in the future (SM 1737-38). For NYSEG, the proposed PBAs consist of the elimination of: deferrals for losses on refunding of various debt issuances; various deferrals related to the provision of gas service; and, amounts related to environmental remediation costs at former gas plant sites. Operating reserves were credited with increased amounts, for accounts held to offset storm and repair costs, to track and control stray voltage problems, and some pension-related expenses (SM 1737-41, Exh. 25). For RG&E, the PBAs consist of eliminating regulatory assets for loss on reacquired debt, for repairs after the 2003 Ice Storm, for property taxes, and for various gas-related deferrals. Operating reserves that would be credited include the major storm reserve and the reserve for remediation of former gas plant sites (SM 1676-79, Exh. 121).

Some revisions to the PBAs Staff proposed in its testimony are needed. After reviewing the testimony of the petitioners' Rate Adjustments Panel (RAP), Staff believes its Exhibit 125, on NYSEG's PBAs, requires revision to the figures provided there for losses on reacquired debt and the purchase gas deferral. A revised Exhibit 125 is attached.

Moreover, NYSEG and RG&E, under their respective Rate Orders, make Annual Compliance Filings (ACF) detailing deferrals, reserve changes, and reconciliations performed in accordance with the applicable Rate Order. These filings are usually submitted within 90 days after the close of the previous calendar year. Review of the most recent ACF filings for calendar year 2007 indicates that some of the deferral numbers Staff used in calculating its PBAs have changed. Such changes should be reflected in the Staff PBA adjustments, based on the best data available.

In particular, review of the most recent RG&E ACF filing supports increasing some of the deferrals used to calculate PBAs for that company. Those amounts should be increased by a total of $4.1 million for RG&E gas to reflect increases in deferrals for property taxes of $3 million, increases to variable rate debt deferrals of $0.5 million, and increases to the pipeline integrity deferral of $0.6 million. A revised Exhibit 121 setting forth these changes is attached.

1. <u>The Rate Base Effect</u>

The petitioners complain that, in its treatment of PBAs related to increases in reserve balances, Staff reduced rate base concomitant with the amount of all its PBA adjustments (with the exception the Saranac IPP cost which does has not have a balance sheet effect). The petitioners believe that it is not appropriate to reduce rate base to reflect amounts related to company-contributed capital (SM 351-52). However once created, PBAs are no longer company-contributed capital -- they are amounts owed to customers for their benefit. Such amounts are routinely reflected in rate base.

Moreover, Staff's proposed rate base treatment merely recognizes how the PBAs are currently treated for rate base. To eliminate the cost of an item, but then continue to carry that cost in rate base, is not logical. Whatever the source of the contributed capital, if the item is written down and no longer exists, it should be removed from rate base.

2. <u>Site Remediation</u>

The petitioners also argue that the Staff calculation of the PBA for site remediation costs is too high (SM 24-25). According to the petitioners, that amount is reduced when ratepayer contributions are offset against it, in conformance with the rate plans and other Commission Orders. Staff, however, used the latest known numbers in calculating the PBAs related to site remediation.

While it is correct that site remediation deferral is reduced by customer contributions made in accordance with the rate plans and other Orders, the utilities, on the other side of the ledger, continually add costs to the site remediation deferral as they revise their estimates of future liabilities for remediation of environmentally hazardous wastes at company owned sites. Those increases to the site remediation deferral generally exceed the contributions ratepayers make to reduce the size of the deferral. Therefore, while it is proper to update the site remediation PBAs to reflect the most current known circumstances, that update will generally raise the value of the PBAs, rather than reduce them, as the petitioners assert.

B. Current Rates Are Excessive

Staff concludes that NYSEG and RG&E are currently over-earning (SM 1741-42, 1679-80). Staff bases its analysis on a return on equity (ROE) of 9.0%, which is reasonable because the revenue decoupling mechanism recommended below will reduce the risk the utilities face. Such a reduction in risk should be reflected in the ROE.

Staff has updated its analysis based on the most recent ACFs it has received. Based on those filings, Staff calculates that NYSEG’s electric operations have earned 17.18%

for the years 2002 through 2006,[53] and its gas operations have earned 10.12% for the years 2002 through 2007, on average. For RG&E, Staff calculates that its electric operations have earned 13.05% for the years 2004 through 2007 and its gas operations have earned 9.16% on average for those years. Given Staff's analysis of ROE, these returns are excessive.

Moreover, if Staff's proposed PBAs are included in the analysis, the returns become even more excessive. Since those PBAs are needed as a condition for approval of this transaction, reflecting them in an analysis of returns is proper. Once PBAs are reflected, NYSEG's ROE is 14.05% for electric and 14.61% for gas. For RG&E, the ROE is 34.32% for electric and 14.67% for gas as revised and reflected in the revised Exhibits 119-120 and 123-124 that are attached. As a result, rate plans that provide for downward adjustments to existing NYSEG and RG&E rates are warranted whether or not this transaction is approved, albeit the rate reductions would be less if the transaction is not consummated.

C. The Revenue Adjustments

Reflecting only the Staff-proposed PBAs in rates is insufficient to ensure that rates will be just and reasonable. The Commission must also assure that NYSEG and RG&E do not

[53] NYSEG was not required to file a 2007 ACF for electric operations because its electric rate plan expired and was superseded by the NYSEG Electric Order Order.

recover excessive expenses, and are not compensated for excessive deferrals. Therefore, if rate plans were required here as a condition for approval of the transaction, there are several regulatory adjustments that should be recognized. In some cases, similar regulatory adjustments are needed for both NYSEG and RG&E. Included among these items are capitalized software and unreasonable deferrals that understate the ratepayers' share of over-earnings.

1. Software Costs

In any new rate plan for NYSEG and RG&E, depreciation and related rate base for capitalized software should be eliminated. The effect of capitalizing software costs, where a utility was allowed to recover the same software expense in rates already, causes ratepayers to pay twice -- once as a rate year expense and then again over time for depreciation and a return on un-depreciated costs.

NYSEG has insisted upon recognizing in rate base capitalized computer software costs even though it has recovered software expenses in rates. It never received permission for this accounting treatment, notwithstanding that it attempted to do so (Exh. 39).

In disputing Staff's analysis of the NYSEG software expense, the petitioners claim that the NYSEG Electric Rate Order resolved the issue in NYSEG's favor. The petitioners interpret that Order as making a distinction between the types of software that were treated as a benefit of the prior merger when Energy East was formed, which should be written off, and the investment in the more recent Customer Care System (CCS), which the Commission decided should not be written off.

The petitioners assert their interpretation of the NYSEG Electric Order also applies to the capitalization of software at RG&E. It therefore rejects Staff’s adjustment to CCS costs included in rate base at that utility as well (SM 374-76). The petitioners add an argument that Staff’s calculation of its CCS adjustment is overstated as well (SM 377-78).

Notwithstanding the companies’ arguments, software expenses are not treated as capital expenditures under the Commission’s Uniform System of Accounts. Before they can be capitalized, permission must be obtained.

Nor is the petitioners’ criticism of Staff’s CCS calculation warranted. The criticism is based on a claim that a portion of the CCS balance was not being depreciated at a time when the depreciation was reflected in Staff’s calculation. Although the company correctly points out that the CCS cost was not being depreciated at that time in common plant accounts, it was, as the company admits, being depreciated in another account elsewhere (SM 431). As a result, Staff’s calculation is correct, because the total depreciation cost remains the same even though the amount was being depreciated in one account at one time and then was transferred to another account subsequently.

Nor, as the petitioners contend, was this issue fully resolved in the NYSEG Electric Order. While NYSEG there was allowed to replace CCS costs in rate base, the accounting there amounted to deferral accounting and applied only to NYSEG electric rates, and was also contingent upon future review and adjustment. The specific concern noted by the Commission in that Order was that the CCS system might be shared with NYSEG affiliates. The Commission did not specifically rule that a change of accounting to allow for capitalization of software cost had been or would be approved. After the Commission Order, NYSEG again sought permission to capitalize software and the Director of Accounting & Finance declined (Exh. 39).

As a result, permission to perform the capitalization for NYSEG gas and RG&E electric and gas was still required, but was not obtained. Moreover, the NYSEG electric amounts remain contingent upon future events. Besides sharing among affiliates to reduce the costs, it is also possible that the CCS cost system itself might become obsolete. In addition, Exhibit 122 shows that NYSEG included software cost in rates as an expense and therefore, the capitalized costs should be removed from future rates.

2. NYSEG ACF Issues

a. NYSEG Over-Earnings

Another regulatory adjustment is required to correct errors in the ACF calculations NYSEG has submitted. In some cases, the company understated monies owed to ratepayers, and in other cases they have overstated monies ratepayers owed them.

In making compliance filings for earnings sharing under its prior electric plan, NYSEG repeatedly performed its calculations using an excessive amount of rate base and an excessive level of equity. It also overstated other deferrals. A proper calculation of earnings sharing, and deferral issues, would increase the amount owed ratepayers by $66.4 million through June 2008, including interest. This amount reflects Staff's revised computation on standby rate deferrals (see SM 1753-55, Exh. 128, which reflects a total amount of $66.8 million).

Tellingly, instead of responding on the merits of Staff's over-earnings calculation, the companies complained that Staff has allowed the overall calculation to rise to unreasonable levels without informing them (SM 360). There is no merit to this baseless accusation, which, conveniently, distracts attention from the fault in the companies' calculations. And the fault clearly lies with the company. It has repeatedly updated prior years' calculations, in some instances making over one hundred revisions to previous calculations. Work papers are not provided with the ACF filings, and must be requested separately. Information requests are not responded to in a timely fashion (DPS-240-33). Staff cannot be expected to complete its audits of ACF filings when the company fails to provide timely and accurate information.

Moreover, Staff has informed NYSEG of the most significant error it makes in calculating over-earnings. Indeed, it provided that assessment in 2003, soon after the very first NYSEG compliance filing on over-earnings was received. As detailed at Exhibit 38, Staff explained to the company that it was overstating the amount of common equity it used to calculate over-earnings, by using an amount that exceeds the actual level of common equity. Instead, the correct procedure is to use the actual amount of common equity, so long as it is no more than 45%. NYSEG artificially boosted its level of common equity so that it exceeded that actual common equity balance in making its compliance filings even though its actual equity ratio was less.

NYSEG nowhere disputes the accuracy of Staff’s criticism of its over-earnings calculation. Moreover, it has ignored Staff’s recommendation on the calculation even though Staff presented that recommendation in June 2003. In any rate plan required here, NYSEG should be required to correct its over-earnings calculation errors and direct to ratepayers the share of over-earnings they are owed.

Continuing its theme that its erroneous calculations are the fault of Staff, NYSEG seeks to blame Staff for NYSEG’s erroneous calculations in a filing made to the Securities and Exchange Commission, where it expresses surprise that Staff in this proceeding has presented its view of the over-calculation. But, given that NYSEG has had Staff views in its possession since June 2003, that surprise is clearly unwarranted.

The petitioners also complain that Staff has never met with them on the over-earnings calculation. But neither NYSEG nor RG&E proposed any process for reviewing ACFs or meeting with Staff in any of the rate plans the Commission has adopted since 2002 for the two companies. And Staff explained why -- these companies have no interest in listening to Staff’s opinions. Therefore, NYSEG cannot exculpate its erroneous calculations by shifting the blame to Staff.

b. The NYSEG Standby Deferral

Another adjustment to NYSEG’s ACF is needed to reflect an error in its calculation of a deferral for standby rate expense. While NYSEG, when standby rates were first introduced, was permitted to recover the difference between those rates and the higher otherwise-applicable tariff rates, it has substantially overstated those lost revenues.[54]

NYSEG commenced calculating the lost revenues attributable to Cornell University (Cornell), its largest standby customer, by comparing the revenues received at standby rates to the revenues received under Cornell's rate classification prior to the time it switched to standby rates. That pre-existing classification was S.C. 7 Transmission - High Load Factor (HLF). But for the period from April 2004 through December 2006, NYSEG changed the calculation. Instead of comparing the Cornell standby revenues to the HLF revenues, it compared them to S.C. 7 Non-HLF revenues. Since the non-HLF rates are considerably higher than the HLF rates, NYSEG was able to substantially increase the amount of lost revenues it claimed (SM 1625-28).

NYSEG justifies its excessive deferral by arguing that, while Cornell met the 68% load factor test for obtaining the HLF rate at the time it switched to standby service, beginning in April 2004, it could no longer meet that test. As NYSEG concedes, however, Cornell met the 68% load factor test at the time it became a standby customer. The purpose of the lost revenue calculation was to enable NYSEG to recover the

[54] Case 02-E-0779, New York State Electric & Gas Corporation, Order Establishing Electric Standby Rates (issued July 30, 2003)(NYSEG Standby Order).

difference between the revenues received under the new standby rates and the revenues it would have received from the customer had standby rates not been introduced. Since Cornell met the 68% load factor test at the time it switched to standby rates, it is clear that the revenues NYSEG actually lost are those in comparison to the HLF rates. Had there been no standby rate, Cornell could have continued to meet the 68% load factor test and could continue to have qualified for the HLF rate.

Indeed, had any rate forecast for NYSEG been made at the time, the assumption would have been to forecast Cornell as an HLF customer. It is that assumption that drives the lost revenue recovery, not events subsequent to the time that Cornell left the HLF rate for standby service, like the loss of qualification for a no-longer relevant S.C. 7 HLF rate.

Moreover, maintaining the 68% load factor was the prerequisite for obtaining the lower HLF rate. In other words, there was a strong incentive for an S.C. 7 customer to qualify for the much lower HLF rate (instead of the default, and higher non-HLF rate), and to keep its load factor at 68% or above in order to do so. Once Cornell switched to standby service, however, there was no longer an incentive to maintain the 68% load factor, because once, on standby service, its rates would remain the same whatever its load factor. Since the 68% load factor test was relevant so long as the customer remained on the

S.C. 7 rate, and was not relevant when it moved to the standby rate, it is also irrelevant for the purposes of determining lost revenues (SM 190-97).

NYSEG contends that using non-HLF rates for the lost revenue calculation was appropriate, because it determined that, as of April 2004, Cornell could no longer meet the 68% load factor test. Since that fact is irrelevant, NYSEG's entire argument collapses. It also fails to address the fact that, under the NYSEG Standby Order, lost revenue recovery was intended to make it whole for the difference between revenues received at standby rates and revenues that would have been received otherwise. Clearly, the revenues it would have received otherwise for Cornell were the HLF rates.

NYSEG also maintains it found an error in Staff's calculation of the lost revenue comparison between standby rates and HLF rates. After review of the company's work papers, (which were submitted as a Highly Sensitive Trade Secret), Staff agrees with the companies' calculation. That calculation, however, should establish the level of lost revenue recovery, not the company's comparison to non-HLF rates.

3. RG&E ACF Issues

Several of RG&E's ACF filings raise rate issues. Corrections should be recognized in any rate plans developed here.

a. Storm Costs

Under its Rate Plan Order, RG&E is permitted to recover storm costs that exceed a $250,000 threshold. As its Rate Plan provides, however, storm restoration efforts costing less than $250,000 will not be recovered and instead "will be charged to RG&E's operating expense."[55] As a result of that provision, storm cost recovery is limited to operating expenses only.

In its ACF filings, RG&E has in at least one instance sought to recover, in addition to operating expenses, capital expenses it attributed to storm damage. Capital costs, however, may not be included in the calculation. Capital costs are recovered through rate base and depreciation, and so are borne by ratepayers irrespective of whether caused by a storm or not. By including capital costs in the storm cost threshold, the company is double counting and therefore its position is incorrect.

Moreover, like any other utility deferral, RG&E may recover only its incremental expenses in the storm damage deferral. The utility already recovered non-incremental expenses, such as labor and benefits for employees who work during a storm, in its rates. To recover those non-incremental

[55] RG&E Rate Plan Order, App., §XI.2.a.

expenses again through the storm damage deferral would be another double-count.

RG&E also claims that it suffered a “heat storm” event that qualifies for storm deferral. Hot weather, however, does not constitute a storm. Rather, it is an expected weather event, and the delivery system should be designed to function when temperatures rise. That is, hot and humid weather are a common summer occurrence within the systems design parameters. RG&E has not demonstrated that heat falls within the definition of a storm event, and so it should not be permitted to recover costs related to such an alleged event (SM 387).

b. The Security Cost Deferral

Staff also objects to RGE’s improper security cost deferral. Again, such deferrals are limited to incremental costs. RG&E seeks to include all costs, thereby double-counting costs it already recovers in rates (SM 166, 391).

c. The VYC Deferral

Under its Rate Plan Order, RG&E was authorized to defer outreach and education (O&E) expenditures for informing customers of its Voice Your Choice (VYC) retail access program, but only if it could show that it was required to expend more than $2 million for that purpose. Through the fourth year of its five year rate plan, RG&E incurred $8.3 million and deferred $6.3 million for recovery from its rate payers. Staff believes the level of expenditures RG&E incurred was excessive (SM 1665-66), because the $2 million spending allowance should have been adequate. Moreover, RG&E has not shown it was required to spend the additional amounts, as is necessary to justify the deferral.

RG&E protests that it was not notified that "Staff was not satisfied with the level of its VYC O&E efforts." The company also claims Staff "review[ed] and discuss[ed]" VYC O&E with it (SM 345-47). That Staff might have "reviewed" the content of RG&E's O&E efforts and determined that it was accurate and informative, however, does not demonstrate it reviewed or accepted the costs RG&E incurred, or that RG&E could not have produced the same materials at lower costs.

A comparison of expenses NYSEG incurred for O&E related to its similar retail access program is instructive. Over the four-year period when RG&E was spending $8.3 million for retail access O&E, NYSEG spent about $2.5 million (SM 439), even though NYSEG has approximately 750,000 customers while RG&E has only 320,000 customers (Exh. 19, Response IBER-340). In other words, for the four-year period, RG&E was spending approximately $6.49 per customer for retail access O&E expenses, while NYSEG was spending $.84. It should be noted that NYSEG was not permitted to recover such O&E expenses through a deferral. RG&E's expenditures are therefore excessive, and the deferred $6.3 million should not be recovered from ratepayers.

Rather than justifying its expenditures with a detailed analysis of the amount it spent, RG&E, like NYSEG in addressing their over-earnings deferral, seeks to blame Staff for the excessive deferral it has accumulated (SM 346, 437-38). Again, like NYSEG, RG&E did not provide for any process in its rate plan for reviewing deferrals as they accumulated. Contrary to the Petitioner's claims, Staff did question the amount of the deferral (SM 1714-1715), and RG&E could have pursued the matter further had it desired. It did not do so.

Therefore, RG&E has failed to show that the $6.3 million it seeks to recover over the $2.0 million it was allowed for O&E efforts is warranted. Recovery of that amount should be denied.

D. Revised Earnings Sharing Mechanisms

The existing NYSEG gas and RG&E electric and gas Rate Plans provide for earnings sharing. Under RG&E's electric earnings sharing mechanism (ESM) the ceiling on earnings is 12.25% annually, while the ceiling for gas earnings is 12.00%. When earnings are calculated, the common equity component of the calculation is limited to the lower of 45% or the company's actual capitalization. Earnings in excess of the sharing thresholds are divided equally between ratepayers and shareholders.

NYSEG's current Gas Rate Plan provides for equal sharing above an ROE of 12.5%. There is no sharing for electric delivery operations, since there is no rate plan currently in effect for NYSEG electric operations. NYSEG's electric commodity earnings, however, are shared however consistent with the NYSEG Commodity Order.[56]

Given that the rates NYSEG and RG&E charge are excessive, and the ROE is stale, in any rate plan adopted as a result of the transaction, the ESMs should be reset at more appropriate levels. The reset should reflect Staff's recommended ROE of 9.0% and the existing common equity ratio of 38%. Staff believes an appropriate ESM would provide for equal sharing of over-earnings between ratepayers and shareholders once earnings exceed a 9.0% ROE. If ROE exceeded 10.0%, amounts in excess of that level would be shared 75% for ratepayers and 25% for shareholders. Ratepayers would retain all of earnings in excess of an ROE of 11.0%. These new ESMs would assure ratepayers that they receive the full benefits directed to them as a result of approval of the transaction.

E. Revenue Decoupling Mechanisms

In a Notice Consolidating Proceedings issued October 22, 2007 in this proceeding, it was decided that issues related

[56] Case 07-E-0479, New York State Electric & Gas Corporation, Order Establishing Commodity Program (issued August 29, 2007).

to the development and implementation of a revenue decoupling mechanism (RDM) for electric and gas sales by NYSEG should be considered in this proceeding. Those issues thereby would become a component of any rate plan devised as a result of this proceeding. While only NYSEG was directed to develop an RDM, it is similarly appropriate to develop such a mechanism for RG&E at this time. In both cases, implementation of an RDM would comply with the Commission's RDM Order.[57] It should be emphasized, however, that accurate sales forecast data is a critical prerequisite to establishing RDMs (SM 1629, 1850).

As a result, Staff proposed RDMs for both electric and gas sales, for implementation by January 1, 2009. For electric, Staff recommended a total delivery revenue reconciliation be designed and implemented for each service class, with the exception of the lighting, buy-back, individually-negotiated contract, and standby classifications (SM 1629).

For a gas RDM, Staff proposes to structure an average pure base delivery revenue per customer (RPC) mechanism. Such RPC factors should be established for each service classification, excepting cooking and large industrial customer classifications that are not amenable to or the focus of, broadly-based energy efficiency programs (SM 1849-50). Pure

[57] Case 03-E-0640, Electric Delivery Rate Disincentives, Order Requiring Proposals for Revenue Decoupling Mechanisms (issued April 20, 2007).

base revenues would be defined as revenues from tariff delivery rates and charges, excluding gross receipts taxes, merchant function charges, billing and payment processing charges, and other credits or surcharges, but reflecting weather normalization adjustments (SM 1850-51). At the end of a designated period, actual pure base revenue would be reconciled against allowed pure base revenue for each classification. Any excess would be refunded to customers while shortfalls would be surcharged to them, on a volumetric basis over the following twelve-month period (SM 1851).

Although protesting that adoption of an RDM should not be a condition of approval of this transaction, NYSEG and RG&E commit to filing RDM proposals before July 1, 2008 (SM 258-62). The companies, however, complain that the RDM mechanisms proposed for electric and gas customer differs substantially from each other (SM 264-65). The companies also detail their proposals for applying RDMs to service classifications, for the annual indexing of targets, and for other adjustments to the mechanisms (SM 271-75). They agree that accurate weather-normalized sales forecast data is needed to establish an RDM (SM 270).

Now that NYSEG and RG&E have committed to file RDM proposals, supported with reliable, rate case-quality data, review of those proposals may be conducted in the second half of this year. In conducting that review, guidance may be obtained from the Commission's recent decisions on an RDM mechanism for Con Edison.[58] The procedures for conducting the RDM review should be established when this proceeding is decided.

F. Capital Expenditures (CAPEX)

Staff proposes electric and gas capital expenditure (CAPEX) accountability mechanisms for both NYSEG and RG&E. These mechanisms ensure that the companies expend the amounts they say are needed to maintain system integrity, reliability and safety, and support customer growth (SM 1617, 1844). CAPEX accountability mechanisms have been a feature of prior rate plans for both NYSEG and RG&E.

1. NYSEG Electric CAPEX

While a CAPEX mechanism is not in effect for NYSEG electric at this time, because one was not imposed in the 2006 NYSEG Electric Order, such a mechanism was in place for electric expenditures during the rate plan in effect from 2002 through 2006. That plan provided that, if NYSEG's actual capital expenditures were $40 million less than the $355 million target at the end of the rate plan, a ratepayer credit would have been

[58] Case 07-E-0532, Consolidated Edison Company of New York, Inc. – Electric Rates, Order Establishing Rates for Electric Service (issued March 25, 2008)(Con Ed Electric Order); Case 06-G-1532, Consolidated Edison Company of New York, Inc., Order Adopting in Part the Terms and Conditions of the Parties' Joint Proposal (issued September 25, 2007)(Con Ed Gas Order).

set at 25% of any excess over the $40 million shortfall (SM 1618-19).

For calendar years 2009 and 2010, NYSEG is currently forecasting total electric capital expenditures of approximately $285 million, not including expenditures on advanced metering infrastructure. This forecast exceeds actual expenditures for the prior two years by approximately $100 million, primarily due to a proposal to reinforce transmission into the Ithaca area.

If this transaction is approved, a new CAPEX mechanism should be adopted for NYSEG (SM 1617-19). If its actual capital expenditures fall short of the forecasted target, it should be required to defer the carrying costs on the budgeted shortfall for the future benefit of customers. The revenue requirement impact would be calculated by applying the company’s annual carrying charge to the annual shortfall from the average annual budget forecast amount. In addition, NYSEG should be required to submit to Staff its management-approved annual electric budget, detailed by project, for each of the next three years, within two months of the date of a decision in this proceeding. A filing detailing actual expenditures, and any variances from forecast, should be made within two months of the end of each calendar year thereafter.

2. RG&E Electric CAPEX

RG&E's current electric rate plan provides for a CAPEX accountability mechanism. Over the five-year term of the rate plan, from 2004 through 2008, expenditures were forecast at $280 million. If total actual expenditures at the end of the rate plan fall short of the target by more than $25 million, ratepayers will receive a credit of 25% of any excess over the $25 million shortfall. If actual expenditures exceed the target by more than $25 million, ratepayers will be charged 11% of any excess over the $25 million amount that has not accrued allowances for funds used during construction (SM 1621-22).

Currently, RG&E's capital expenditures substantially exceed the $280 million target, because the company has exceeded forecast costs for the Rochester Transmission Project (RTP) by approximately 60%. Moreover, the company has alleged that it may need to construct additional transmission into the Rochester area, notwithstanding the RTP upgrades. In addition, the company may have improperly included software costs in its capital expenditures (SM 1622-23).

If this transaction is approved, a new CAPEX mechanism should be adopted for RG&E, for 2009 and 2010. If actual 2009 and 2010 expenditures fall short of Staff's adjusted forecast of $182 million, RG&E should defer a credit equivalent to the carrying costs on the budget shortfalls, for future benefit of customers, similar to the mechanism proposed for NYSEG. Filing requirements similar to those proposed for NYSEG should be imposed on RG&E for its company-approved budgets and actual expenditures (SM 1623).

The mechanism, however, should not provide for payment of an incentive to RG&E if capital expenditures are exceeded. Such an incentive does not necessarily inspire the company to improve service to ratepayers, but instead rewards it for any spending in excess of the target, even if the spending is excessive or imprudent. It also improperly rewards efforts to under-forecast the targets. Such an incentive is also unneeded, because, where appropriate, the company can accrue AFUDC carrying charges before a project enters service and is still under construction (SM 1624).

3. NYSEG and RG&E Gas CAPEX

CAPEX mechanisms are also needed for gas construction budgets at NYSEG and RG&E. For the next three years, NYSEG has forecasted its capital expenditures at $20.8 million per year, while NYSEG is projecting $19.3 million per year (SM 1845-46). Those forecasts seem reasonable, based on recent actual historic experience (SM 1846).

Staff proposes CAPEX mechanisms for NYSEG and RG&E gas that are similar to those proposed for NYSEG and RG&E electric. Specifically, if the actual annual amount expended by either company is less than the annual average amount budgeted for the three-year period from 2008 through 2010, the company would be required to defer the carrying costs on the budgeted shortfall for the future benefit of customers. In addition, the company should be required to provide Staff with their management-approved annual gas budgets, detailed by project, for each of the next three years. Each company should also be required to make a filing detailing their annual expenditures, and explain any variances from forecast, within two months after the end of each calendar year (SM 1847).

NYSEG and RG&E propose that the CAPEX mechanisms include an incentive. They maintain that any amount they overspend above their capital budgets should be subject to a carrying charge accruing to the benefit of shareholders (SM 385-86). To establish spending levels and the reconciliation methodology, the companies would conduct collaborative meetings.

As with electric CAPEX mechanisms, gas CAPEX accountability mechanisms are necessary to ensure that NYSEG and RG&E perform budgeted capital improvement work that is necessary to maintain system reliability and safety. Moreover, if forecasted capital expenditures are reflected in rates, but the company does not expend those amounts, it retains that benefit for shareholders. In an era when infrastructure needs call for more attention, not less, this outcome is unacceptable.

As with the electric CAPEX mechanism, the companies should not be rewarded if they exceed forecast expenditures. Again, this type of incentive rewards the company even if their spending is excessive or even imprudent. Utilities should not earn incentives in such instances. Finally, final CAPEX accountability mechanisms can be addressed, in accordance with these principles, in any rate plan process required as a condition of the approval of this transaction.

G. Service Quality Measures

As the KeySpan/Grid Order provides, metrics for the quality of electric reliability, gas safety and customer service performance has become a common feature of rate plans in place for a majority of the State's electric and gas utilities.[59] Those features were present in the KeySpan/Grid proposals for justifying approval of their merger. The Commission, however, found that the initial proposals presented by the parties supporting that merger were insufficient in one important, material respect. National Grid's acquisition of KeySpan, similar to the proposed Iberdrola acquisition of Energy East, posed significant financial risks to ratepayers.[60] The Commission was concerned that those financial risks could

[59] KeySpan/Grid Order, p. 143.

[60] Because of the financial risks the transaction posed, National Grid, as well as KEDNY and KEDLI, were required to adopt enhanced assessments and metrics.

translate into incentives to undermine service quality, as spending on preserving that quality of service was sacrificed to the goal of meeting the financial exigencies of the holding company parent.

As a result, the Commission doubled the rate adjustments the parties proposed for any failure to satisfy the service quality metrics. Moreover, it ruled that the rate adjustment assessment should be tripled during any year where a dividend restriction was triggered and a metric was not met. The amount would be quadrupled for any year in which, after a failure to meet a metric in any two of the prior four years, that metric was again missed. Finally, the Commission also stressed that it would review the metrics themselves in the rate plans that it required be developed promptly after the merger was approved.

Staff in this proceeding has presented updated metrics and rate adjustments supporting those metrics that could be included in rate plans for NYSEG and RG&E. As is common to such rate plans, the metrics address electric service reliability, gas service safety and reliability, and customer service performance.

1. Gas Safety and Reliability

Consistent with the KeySpan/Grid Order, Staff proposed new rate metrics for NYSEG and RG&E gas safety and reliability, using basis point rate assessments that approximately reflect those required in the KeySpan/Grid Order. These higher assessments are needed because Iberdrola’s acquisition of Energy East creates incentives for the parent to squeeze capital out of the New York subsidiaries by cutting operational costs, even when the cost reductions might adversely affect safety and reliability (SM 1837-38).

As to the metrics, Staff derived them from historical performance data and forecasts of expected future capabilities (SM 1836). As is common to gas safety and reliability measures at other utilities, Staff established metrics for the replacement of leak-prone pipe and leak-prone gas services; for leak management, by setting targets for achieving year-end backlogs of total leaks; for the prevention of excavation damages (divided into categories of overall damages, damages due to mis-marks when responding to one-call tickets requesting the identification of buried gas piping, and damages caused by utility crews and contractors); and, responses to gas emergencies, measured by the percentage of calls responded to within specified time frames (SM 1802-39).

In response, the companies complain that the proposed enhancements are unnecessary and unfair. NYSEG and RG&E maintain that they are ranked among the top performers in New York in virtually every gas safety category, and that their performance has improved significantly over the last five years. They also claim that Iberdrola’s acquisition of Energy East will improve the performance of NYSEG and RG&E, as they will benefit from the new parent’s expertise (SM 207-208).

The NYSEG and RG&E gas safety presentation is riddled with inconsistencies. On one hand, they claim that Iberdrola’s global experience and expertise will improve their performance (SM 253), but on the other hand they also insist that their commitment to high performance levels “will not change after the proposed transactions” (SM 120). The companies were also unable to explain exactly how Iberdrola’s acquisition would lead to improvements in their performance (SM 245-47). Nonetheless, they concede that rate assessments encourage utilities generally to achieve compliance with their metrics for gas safety, which benefits customers (SM 246, 250).

Other contradictions undermine the NYSEG and RG&E gas safety testimony. They claim that they are the only local distribution companies (LDCs) in the State that, in 2006, were not required to self-assess their performance and draft action plans on improving that performance (SM 207). But that statement is incorrect, because at least two other LDCs were not directed to participate in the self-assessment process (SM 229). The petitioners also could not arrive at the correct number for gas services replaced at NYSEG during 2005, providing at least three different figures for that year (SM 240-41, Exh. 18, Exh. 22).

NYSEG and RG&E also complain that Staff would have them increase capital spending on gas safety by $1.6 million per year, when that figure does not include capital costs for a significant increase in service replacements, and does not account for the costs of replacing pipe "as required for highway projects" (SM 212-13). When it was pointed out to the companies that Exhibit 18, page 2 of 40, clearly showed that the costs of incremental service replacements was included, the LDCs had no response (SM 232-33).

In addition to wrongly contending that Staff failed to account for the costs of highway-related projects, the LDCs' presentation on this point is so confusing as to lack credibility (SM 230-37). The confusion begins with the discrepancies between the "miles of pipe replaced" as listed in their testimony (SM 210), and the figures "miles of pipe replaced" as listed at Exhibit 18, page 7 of 40. The companies explain that "miles of pipe replacements related to highway projects" are not included in the testimonial numbers. They contend, however, that those "highway project pipe miles" are included in the Exhibit 18 figures. Notwithstanding that they say the "highway replacement project miles" are included in that Exhibit 18, they then deny that "highway project <u>costs</u>" are reflected in Exhibit 18 (SM 230-35). Since it is the companies that initially provided all of the underlying data in Exhibit 18 (see Exh. 19, Response IBER-0194), it was their responsibility to include “highway project costs” in that data as well as “highway project pipe miles.” Why they did not do so is not explained.

The LDCs also assert that Staff is wrong in asserting that the companies’ performance in the damage prevention metric slipped during 2007 as compared to 2006 (SM 217-18). They hypothesize that additional construction in 2007 carried with it increased opportunities for damages. One-call ticket data, however, undermines their contention. Comparing the one-call tickets for 2006, as provided at Exhibit 18, page 36 of 40, to the 2007 one-call data from Exhibit 24, shows that one-call tickets for the two companies actually decline, from 117,890 for 2006 to 116,483 for 2007. Since the data shows construction activity actually declined, As a result, the deterioration in performance could not be traced to an increase in that activity. Exhibit 24 also shows that RG&E’s total leak backlog increased during 2007 as compared to 2006.

Two factors therefore affect Staff’s increased targets for the various service quality metrics. On one hand, Staff recognizes the improvements in performance that NYSEG and RG&E have made over the past five years. It is those levels of performance that are the basis for the metrics, not, as the company claims, the metrics from NYSEG and RG&E gas rate plans that are now five years old. Since, as the companies concede, they should constantly strive to improve their gas safety performance, metrics and targets from dated rate plans are no longer relevant (SM 213).

On the other hand, 2007 performance as compared to 2006 indicates that slippage in company performance may occur. When the many incentives for poor performance Iberdrola's acquisition of Energy East creates are recognized, the threat to gas safety performance is heightened. As a result, the metrics and rate adjustment assessments Staff proposes should be adopted.

2. Customer Service Performance

Another essential element of service quality is customer service performance. NYSEG's current metrics for that measure are categorized into an overall customer service satisfaction index, a contact satisfaction index, and the PSC complaint rate. The satisfaction index is measured through an annual survey of a representative sample of customers in the utility's service territory. The contact index is based on a monthly survey NYSEG conducts. The PSC complaint rate is the average annual rate of monthly complaints to the Commission per

100,000 customers. In 2006, NYSEG incurred a rate adjustment for failure to meet the contact index metric.

RG&E’s service quality measures consist of six measures: the PSC complaint rate; the customer interaction service index; appointments kept; calls answered within 30 seconds; billing accuracy; and, estimated meter readings (SM 1875-76, SM 1877-78). In 2006, RG&E failed to satisfy the metric for calls answered within 30 seconds.

Staff proposes that the service quality measures for NYSEG and RG&E be made more consistent with each other. To achieve this goal, the measures currently applicable to RG&E should be applied to both companies. Moreover, a new measure, Escalated Complaint Response Time (ECR), should be added to both companies’ measures. This latter measure captures the average number of days each utility needed to respond to escalated complaints made to PSC Staff. Escalated complaints are those that the utility failed to satisfy after initial referral from Staff (SM 1878-80).

Staff’s proposed metrics are set forth at Exhibit 136. Staff would also double the current rate adjustment assessments for failure to satisfy the new metrics, consistent with the KeySpan/Grid Order (SM 1880-82).

NYSEG and RG&E complain that Staff’s rate assessments are excessive (SM 130-33). They assert that they are among the better performers in service quality among New York’s utilities. They dismiss their failure to meet some metrics in 2006, saying that implementation of a new customer information system inevitably led to a deterioration in those metrics, as the mistakes accompanying introduction of any new system were corrected (SM 123-26).

Staff’s rate assessments, however, are justified by the Commission’s decision in the KeySpan/Grid Order. Nothing the companies have submitted warrants reaching conclusions contrary to those in that Order, or countermands Staff’s contention that Iberdrola’s acquisition will create incentives for the deterioration of those performance metrics. As to the metrics themselves, the companies overstate their past performance, glossing over the metrics they have failed. Staff’s metrics are needed to create an incentive for the level of customer service performance commensurate with the quality of service customers deserve.

Although the companies oppose the introduction of the new ECR metric, it is appropriate for Staff to propose such measures at any time. The metric was fully justified by Staff’s testimony. It should be adopted.

The companies also oppose setting metrics for each other at the same levels. They maintain that, even though they are both subsidiaries of Energy East, their operations remain sufficiently separate to justify separate metrics (SM 128-29). Use of the best-available metrics, however, is appropriate for any utility, unless deviations are justified. The companies have presented to such justification.

Staff proposes that NYSEG and RG&E enhance their reporting of customer performance measures, in particular by submitting an annual report on contact satisfaction surveys. NYSEG and RG&E oppose the additional reporting requirement as unduly burdensome (SM 126-27). Staff has justified the additional requirement, because it is needed to alert Staff to any degradation of customer service (SM 127, Exh. 118). The requirement should be adopted.

3. Electric Reliability

Staff proposes to continue the existing reliability performance mechanisms in place at NYSEG and RG&E, making no changes to the existing metrics and targets (SM 1856-59). Staff would, however, increase the revenue assessments for failing to achieve the targets in accordance with the KeySpan/Grid Order, by doubling the level of the assessments. If, in any year subsequent to a year in which a target is missed, the target is again not satisfied, the applicable rate adjustment would be doubled again for that year (SM 1859).

The electric reliability metrics and targets in Staff’s electric reliability performance mechanism are similar to those in place at all of New York's major electric utilities. NYSEG and RG&E do not oppose the metrics and targets, although they correctly point out that NYSEG is not currently subject to any rate assessments for failure to meet the targets (SM 146).

NYSEG and RG&E argue, however, that modeling the rate assessments for the future on the requirements of the KeySpan/Grid Order is improper. They maintain that they have an excellent record of satisfying their targets, and so imposing higher assessments on them as a result of the Iberdrola acquisition is unreasonable (SM 146-47).

An electric reliability performance mechanism is a common feature of electric utility rate plans, and should be required of any such plan adopted here. Since the characteristics of Iberdrola's proposed acquisition strongly resembles the circumstances at issue in the KeySpan/Grid Order, that Order is precedent on the level of rate assessments that are needed.

H. Retail Access Issues

The Staff Policy Panel addressed several retail access unbundling issues, including unresolved billing issues related to NYSEG and RG&E. These utilities currently apply their billing charges in a manner that does not conform to Commission policy and orders. The Staff Policy Panel also testified that the unbundling of rates from back-out credits to unbundled charges for service should be completed. As well, the Panel addressed the establishment of an ESCO Referral Program for both NYSEG and RG&E (SM 1437).

1. Bill Issuance and Payment Processing

The Commission has addressed bill issuance and payment processing (BIPP) twice on a generic basis.[61] In both cases, the Commission ruled that the customer should only pay a utility for BIPP service when receiving from the utility both delivery and all commodity services (SM 1438-1439). When the customer receives a consolidated bill, which includes ESCO as well as utility charges, from the utility, the utility collects a billing fee equal to the amount of the BIPP charge from the ESCO or ESCOs. Where a single ESCO serves the customer for either all commodity or one of two commodities taken, it still is required by the Commission to pay the entire BIPP fee. Where there are two ESCOs serving the customer, one for electricity and one for natural gas, the ESCOs would each pay half of the BIPP fee. As a result, where an ESCO is providing all or one part of a dual commodity service, the companies should not charge the customer for billing services because the ESCO is already paying them (SM 1439).

[61] Cases 98-M-1343 and 99-M-0631, Customer Billing Arrangements, Order Providing For Customer Choice of Billing Entity (issued May 18, 2001); Case 00-M-0504, Competitive Opportunities, Order Directing Submission of Unbundled Bill Formats (issued February 18, 2005)(Bill Format Order).

When the NYSEG and RG&E retail access rate design was accomplished through back-out credits, those credits were set in conformance with the Commission’s Orders on BIPP. But when the utilities converted the back-out credits to charges, they began using two separate BIPP charges, one for electric service and one for gas service, imposing on dual commodity customers a total BIPP charge approximately double the amount a single commodity service customer pays. The Commission, however, has determined that the BIPP charge should be one charge that is the same whether the customer is a single commodity service customer or a dual electric and gas commodity service customer (SM 1440).

Besides departing from the requirements of Commission orders and policy, the approach NYSEG and RG&E take to BIPP is inconsistent with the BIPP charge practices of the other New York utilities. The approach also does not reflect the actual costs NYSEG and RG&E incur in providing BIPP. A large part of BIPP costs are related to the costs of the supplies needed to prepare bills, such as ink, paper, and envelopes; the machines that print, assemble, and put the bills in envelopes; and the postage. These costs are calculated per bill, and do not vary whether one commodity is taken from a utility competitor or both electric and gas commodity are so purchased (SM 1440-1442).

The Commission has repeatedly recognized and stated that BIPP costs should be paid by the customer only when the customer takes all commodity from the utility. When one or more commodities are purchased from competitive suppliers, however, the ESCO pays the charge (SM 1443). For example, the Commission stated: “[s]ince the billing charge is for a competitive service and is not charged to retail access customers receiving consolidated bills, from either the utility or the ESCO, it should not be subsumed within delivery.”[62] Therefore, billing is a single competitive service paid by customers only when they receive no commodity service from a competitive supplier or ESCO.

More recently, the Commission distinguished “the gas Merchant Function Charge” from “the account level billing and payment processing charge.”[63] This further clarified that there should be a single BIPP charge, not two separate charges for electric and gas (SM 1443-1444). In any rate plans required here, the Commission should insist that NYSEG and RG&E comply with established BIPP policy. So considering BIPP in a rate plan context should resolve the companies’ concerns about addressing this issue outside of a rate proceeding (SM 173).

[62] Bill Format Order, p. 23.

[63] Con Ed Gas Order, p. 9.

2. Further Unbundling of Utility Rates

The unbundling process for the Energy East utilities is not yet complete. While many of these utilities' charges have been unbundled from rates and are no longer subject to back-out credits, RG&E in particular should be required to file revised tariffs that convert all existing back-out credits to unbundled charges in a revenue neutral manner, including the merchant function credit and metering back-out credits (SM 1444).

3. ESCO Referral Programs

Neither NYSEG nor RG&E currently operate an ESCO Referral Program, where an electric or gas utility offers customers telephoning its call center with a non-emergency inquiry the opportunity to enroll with ESCOs that offer a uniform discount, over an introductory trial period, from the price the utility charges for commodity service (SM 1444-1445). Recently, the Commission ordered KeySpan and NFG, two New York utilities currently without ESCO Referral Programs, to initiate collaboratives to investigate the possibility of initiating such programs.[64] In each case, the Commission required each utility to embark upon a collaborative and to make a filing describing

[64] Case 06-G-1185, KeySpan Corporation, Order Adopting Gas Rate Plans For KeySpan Energy Delivery New York and KeySpan Energy Delivery Long Island (issued December 21, 2007); NFG 2007 Rate Order.

the relevant costs, benefits and best practices of an ESCO Referral Program, in sufficient detail to allow the Commission to reach a decision on such a program (SM 1445).

NYSEG and RG&E have, respectively, filed proposals, on September 1, 2006 and October 23, 2006, to institute ESCO Referral Programs, upon which the Commission has not yet acted. Subsequently, in the NYSEG Commodity Order, the Commission allowed NYSEG to pursue the development of an ESCO Introduction Program that could serve as a substitute for an ESCO Referral Program. NYSEG was directed to commence a collaborative on the content and costs of an ESCO Introduction Program. Negotiation in that collaborative are ongoing (SM 1445-1446).

Since the original ESCO Referral Program filings of RG&E and NYSEG are well over a year old, the Commission should impose on NYSEG and RG&E requirements regarding ESCO Referral Programs that are similar to the requirements the Commission imposed on KeySpan and NFG (SM 1447). There is no basis for the companies’ contention that they should be distinguished from KeySpan and NFG (SM 178-82).

Any results of NYSEG’s ESCO Introduction Program collaborative would be folded into the filing that utility would make. NYSEG’s filing should include cost and program component information on an ESCO Introduction Program, and compare that program to the costs and best practices for implementing an ESCO

Referral Program (SM 1447). NYSEG's existing ESCO Introduction collaborative, however, should be suspended until the Commission decides this proceeding.

I. Other Rate Plan Issues[65]

1. Gas Pension Expense for NYSEG

Under the NYSEG Gas Rate Plan Order, the company is permitted a limited true-up of pension expense (SM 369-70). Staff proposes to eliminate this true-up in the future (SM 1751). The true-up that is performed uses outdated financial metrics and is not consistent with the approach to pension deferrals taken in the Commission's Policy Statement on Pensions and OPEB.[66] The NYSEG Electric Order used the latest available pension expense forecast and a similar deferral for electric service was not provided. Therefore, once NYSEG's gas rate plan expires, the partial true-up provision should disappear with it, and gas rates should reflect future pension expenses consistent with latest available information with no true up.

[65] A number of minor adjustments to Staff's proposed rate plan income statements are needed. Staff's revised income statements reflect those changes. Further changes can be expected as the rate plans are developed, according to the process the Commission directs, if this transaction is approved subject to conditions.

[66] Case 91-M-0890, Accounting for Pensions, Statement of Policy and Order Concerning the Accounting and Ratemaking Treatment for Pensions and Post Retirement Benefits Other Than Pensions (issued September 7, 1993).

2. AMI

NYSEG and RG&E have proposed to install advanced meter infrastructure (AMI) in their service territories, and recover the costs of AMI in a surcharge to customers (SM 1743-51). Because AMI is an extensive meter replacement program that raises numerous and complex issues, it requires additional review. The accuracy of the companies' estimates of costs and savings and their surcharge calculations are questionable. Moreover, the program must be coordinated with the Commission's evolving standards on AMI.[67]

Particularly troubling to Staff is the companies' failure to address the fact that, if AMI meters are installed, the existing meters would be retired. Upon retirement, depreciation of the meters should cease, but, under the companies' approach, they would continue to recover the depreciation expenses reflected in their existing revenue requirements (SM 1743-50). A claim that the public policy benefits attending installation of AMI justify continued depreciation recovery is not sufficient to show that recovery is actually warranted (SM 407-08). Only a more detailed cost analysis can make that demonstration.

[67] See, e.g., Case 02-M-0514, Competitive Metering, Order Requiring Filing of Supplemental Plan (issued December 19, 2007).

A careful approach to the AMI issue is needed. Therefore, no AMI costs should be recognized in any rate plan adopted as a result of this proceeding until additional proceedings on AMI have been conducted; proposals to install AMI in the NYSEG and RG&E service territories have been carefully analyzed; and, all of the questions Staff has raised here have been answered. Such further proceedings should be conducted as the Commission directs in its ongoing development of AMI policy.

3. Gas Cost Incentive Mechanism

Under the currently-effective NYSEG and RG&E Gas Rate Plans, certain costs are shared between ratepayers and shareholders through two Gas Cost Incentive Mechanisms (GCIM-1 and GCIM-2). Consistent with policies applicable to all New York LDCs,[68] GCIM-1 (Utility Stand-Alone Activities) establishes an incentive for NYSEG and RG&E to maximize revenues from existing capacity and supply contrasts and to mitigate impacts of excess system capacity during off peak periods or when not utilized by firm core customers. Unlike GCIM-1, GCIM-2 (Energy East's Multi-State LDC Activities) is specific to Energy East, and provides for a sharing of savings attained through specific joint Energy East affiliate optimization of gas supply

[68] See Case 93-G-0932, Restructuring Natural Gas Markets, Opinion No. 94-26 (issued December 20, 1994).

portfolios, including gas storage, transportation and pipeline capacity turn-back activities (SM 1847-48).

GCIM-2, however, unnecessarily over-compensates the two LDCs. They are already required to procure and manage gas supply for their customers on a least cost basis, pursuant to PSL §§66(e) and (f). Moreover, the Commission's regulations, at 16 NYCRR §61.3.6, guide their gas purchasing policies and load management practices. Rewarding the two LDCs for performing their duties with the prudence expected of utility management is no longer appropriate.

NYSEG and RG&E argue that GCIM-2 should be continued. They believe that the joint optimization practices between the two of them have yielded savings, and they point to the Commission's Orders and other documents where GCIM-2 methodologies were approved or established (SM 384-85).

That GCIM-2 was a feature of the joint proposals adopted by the Commission when establishing existing rate plans does not demonstrate that its continuation is appropriate when those rate plans expire as of December 31, 2008. Those joint proposals, like any settlement, are not precedent for continuation of any of their terms or conditions.

Moreover, the LDCs are expected to prudently manage their gas transportation storage and pipeline capacity activities for the maximum benefit of their ratepayers. It is not appropriate to reward the companies for the performance of the duties expected of them. Utility managements are expected to make that type of decision prudently, and are compensated accordingly.[69] The reward for merely prudent operation inherent in GCIM-2 is no longer appropriate, and the mechanism should be eliminated from any future rate plan.

4. Low Income Programs

NYSEG and RG&E currently administer several ratepayer-funded low-income programs, including NYSEG's Power Partner Program for electric customers, its Affordable Energy Program for gas customers, and RG&E's Residential Energy Customer Assistance Program (RECAP) and Non-Heating Gas Low-Income Program for gas customers. RG&E, however, does not currently conduct a low-income program for its electric customers (SM 1886-90). Staff proposes continuation of the existing programs, at increased funding levels, and establishing a low-income electric program for RG&E modeled on NYSEG's Power Partner Program. While willing to continue their existing programs, NYSEG and RG&E oppose increasing their funding, and oppose establishing an electric low-income program at RG&E without providing for its funding in rates (SM 135-37).

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[69] Case 90-E-0775, Consolidated Edison Company of New York, Inc., Order Accepting Contracts for Filing and Denying Petition (issued December 10, 1990); Case 92-E-0032, Erie Energy Associates, Declaratory Ruling (issued March 4, 1992).

Low-income programs are now a common feature of all electric and gas utility rate plans. Staff's proposed levels of funding are generally commensurate with those at other utilities. There is no reason to exempt NYSEG and RG&E from this generally applicable requirement. Moreover, NYSEG has successfully operated separate electric and gas low-income programs for many years. RG&E should be able to do the same. As with all other rate issues related to this proceeding, the costs of these programs should be addressed when a rate plan is developed for these utilities, and, to the extent petitioners bear those costs, they could be considered a benefit of the transaction (SM 1890).

5. O&E Plan Filings

Staff proposes to continue existing O&E plan filing requirements for NYSEG and RG&E's customer information efforts, bolstered by more detailed budget reporting (SM 1890-91). NYSEG and RG&E oppose additional reporting. As regulated utilities, however, they are required to provide the information necessary for Staff to perform its oversight function (SM 138).

6. RG&E's Commodity Service Option

Both NYSEG and RG&E currently offer commodity service at a fixed price option (FPO). The conditions governing NYSEG's FPO offering, however, was substantially revised in 2007, in the NYSEG Commodity Order. There, the mark-up NYSEG earned on the

FPO offering was substantially reduced, because the Commission found it excessive, and the earnings sharing mechanism for revenues attributable to the FPO was substantially reconfigured. In comparison to NYSEG, RG&E now over earns substantially on its commodity offering.

In any new rate plan adopted here, the requirements of the NYSEG Commodity Order should be applied to RG&E's FPO offering (SM 1669-73). The mark-up RG&E can earn should be reduced to the level NYSEG currently earns. The earnings sharing mechanism should be modified to conform to the NYSEG conditions, with 85% of the over-earnings accruing to ratepayers and 15% accruing to shareholders, above a threshold level of $4.5 million of pre-tax earnings that shareholders may retain. The threshold is comparable, for RG&E's size, to the level of earnings NYSEG was allowed to retain.

The petitioners claim that RG&E's existing FPO mechanism should continue in effect. The only reason they offer justifying retention, however, is the inclusion of the existing provisions in the existing rate plan (SM 379). Once that rate plan expires, on December 31, 2008, there is no reason to continue its provisions and the more-recent guidance from the NYSEG Commodity Order should be substituted instead.

7. <u>The Ginna Shortfall</u>

RG&E retains, for the benefits of its ratepayers, an

Asset Sale Gain Account (ASGA), where the proceeds from the profit on the sale of the Ginna nuclear power plant are deposited. Consistent with its electric rate plan, RG&E has reduced the ASGA balance over time by making refunds to customers and otherwise drawing down its contents in conformance with the rate plan.

The most important credit to ratepayers funded through the ASGA is the Power Purchase Agreement (PPA) credit. This credit represents the difference in the costs of purchasing power under contract from the current owners of Ginna and the cost that was embedded in RG&E's rates prior to the sale of the facility to those owners.

The funding of the PPA credit steadily depletes the ASGA (SM 1682-85). Staff believes, and the company has confirmed, that continued funding of the credit will empty the ASGA by the end of 2010 (Exh. 19, Response IBER-0346). Without the credit, RG&E's rates will increase by about $60 million per year, to fund the costs of power purchases no longer offset by the credit.

This looming structural deficit in RG&E's rates is best addressed through Staff's PBAs, as discussed above. The petitioners' solution is to keep rates constant and eventually defer the $60 million yearly cost, creating a regulatory asset in the amount of that deferral (SM 392). The size of this regulatory asset would continue to increase until electric rates are reset at RG&E.

The petitioners' proposal would destabilize RG&E's rates. The magnitude of the deferral would cause a sharp rate increase once its recovery is sought. This impending rate shock must be avoided. Addressing the effect of the loss of the PPA credit in Staff's PBAs provides long term rate stability. In contrast, the company's answer is to ignore the impending crisis and eventually increase rates.

CONCLUSION

For all the reasons stated above, the Commission should deny the petitioners' request for approval of Iberdrola's acquisition of Energy East. If the Commission decides to instead approve the transaction, it should do so upon the conditions that Staff has recommended. To ensure that ratepayers receive the benefits of these conditions, new rate plans should be adopted for NYSEG and RG&E, with an effective date of January 1, 2009.

Respectfully submitted,

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Albany, New York